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The Constitution's Dormant Commerce Clause Limits The Power of States to Tax Their Residents — Comptroller of the Treasury Of Maryland v. Brian Wynne et ux.

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On May 18, 2015, the Supreme Court in a surprisingly close 5-4 decision found that Maryland's failure to grant a credit against its county income tax for out-of-state income taxes paid by Maryland residents violates the Constitution's Commerce Clause. In *Comptroller of the Treasury of Maryland v. Brian Wynne et ux.*[1] the Court held that the failure to grant the credit incentivized taxpayers to conduct intrastate rather than interstate business in violation of the judicially created "dormant" or "negative" Commerce Clause. The majority and dissenting opinions illustrate the enormous differences among the Justices regarding their views of the power of states to tax their residents.

An ideologically diverse majority of Justices Breyer, Sotomayer, Kennedy, Roberts and Alito (who authored the opinion) looked to well-established judicial precedent interpreting the Commerce Clause to apply to actions of states as well as the federal government. The principal dissent by Justice Ginsburg (joined by Justices Kagan and Scalia) argued that the Commerce Clause should not interfere with policy decisions by states to tax their residents who consume state services. Finally, in separate dissents, Justices Scalia and Thomas condemn the Court's interpretation of the Commerce Clause arguing that the Constitution does not prohibit states from discriminating against interstate commerce. These widely differing views over a relatively technical issue regarding the authority of states to tax their residents illustrate a more fundamental division among the Justices regarding the Constitution and the power of government which will undoubtedly appear in future decisions.

MARYLAND STATUTE

Like many states, Maryland taxes the worldwide income of its residents, with the tax consisting of a state income tax set by the legislature[2] and a county tax that applies only to residents of each county at a

land shareholder, the credit allowed to the shareholder may not exceed his or her pro rata share of that tax.[7]

But Maryland did not allow a similar credit for out-of-state taxes against its county income tax.[8] As a result, a Maryland resident who paid out-of-state income taxes in excess of the Maryland state income tax on the out-of-state income could not apply the excess to offset the county income tax. For example, if a Maryland resident's state income tax rate is 5% and his county's income tax rate is 2% and he earns all of his income in another state with a rate of 6%, he owes no state tax but still owes the 2% county income tax. In short, income a Maryland resident earns outside the state was potentially taxed twice.

FACTS OF WYNNE

Brian and Karen Wynne, residents of Howard County, Maryland in 2006, owned stock in Maxim Healthcare Services, Inc., an S corporation ling income tax returns in 39 states. In 2006, the Wynnes earned over $2.6 million in taxable income, much of it from their 2.4% interest in Maxim, paying approximately $208,000 of Maryland and Howard County income tax. Because of Maxim's business in other states, the Wynnes claimed a credit of $84,550 for income taxes paid by Maxim on their behalf to other states attributable to their distributive share of Maxim income reported on their Maryland return.

The Wynnes did not le personal income tax returns in the other states, but rather Maxim led "composite" returns on behalf of all its shareholders reporting the tax paid attributable to the Wynnes on their Form K-1. To relieve owners of partnerships and S corporations of the burden of ling nonresident returns in states where the pass-through entity does business most states permit the entity to le a return on behalf of the nonresident owners who have no other income in that state. Generally, however, when a nonresident owner consents to be included in the composite return, the individual is taxed at the state's highest marginal rate.

The Wynnes credited these taxes against their Maryland tax, including the county tax. Citing Maryland's statute that a resident may claim a credit only against the *state* income tax, the Comptroller of the Treasury disallowed the credit against the Howard County tax resulting in an adjustment of approximately $25,000.

LOWER COURTS' OPINIONS

The Wynnes appealed the Comptroller's decision to the Maryland Tax Court where they argued, for the rst time, that the limitation of the credit to the state tax for taxes paid to other states discriminated against interstate commerce in violation of the Commerce Clause. The Tax Court summarily held in favor of the Comptroller, but upon appeal, the Circuit Court for Howard County and ultimately Maryland's highest court, the Court of Appeals,[9] held that denying the credit or not allocating the Wynnes' income among the states where it was earned was unconstitutional. In nding for the taxpayers, the Court of Appeals pointed out that while the Tax Court is an administrative agency of the state, its decisions should generally be afforded deference; but in this case, because the issue was on a question of constitutional law, courts could overrule the agency's determination.[10]

In its decision, with two dissents, affirming the Howard County Circuit Court, the Court of Appeals evaluated the validity of Maryland's statute under the Commerce Clause using the seminal four-part test of Complete Auto Transit, Inc. v. Brady,[11] which requires a tax arising from activity (1) have substantial nexus with the taxing state; (2) be fairly apportioned; (3) not discriminate against interstate commerce; and (4) be fairly related to service provided by the taxing state. The Court of Appeals held that the failure to grant a credit for the out-of-state taxes against the county tax violated both the fair apportionment and nondiscrimination requirements of Complete Auto.[12]

Speci cally, the Court of Appeals found that the Maryland statute was not fairly apportioned, i.e., "internally consistent," because if all other states adopted Maryland's rule, interstate commerce would be taxed at a higher rate than intrastate commerce.[13] Lacking internal consistency the court held that the tax discriminated against interstate commerce because it denied residents a credit on income taxes paid to other

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[7] Id. §10-703(c)(2). Maryland adopts the rules of the Internal Revenue Code for the treatment of S corporations so that income, deductions credits, etc. of the corporation pass through to its shareholders. See I.R.C. §1366.

[8] Id. §10–703(a). In Stern v. Comptroller of the Treasury, 316 A.2d 240 (1974), the Court of Appeals had held that a credit was required against the county tax under Maryland law, but the state legislature promptly responded by amending the statute to make clear no credit could be claimed against the county tax. The Court of Appeals then, without reference to the Commerce Clause, upheld the right of the legislature to change the statute to deny the credit for out-of-state taxes against the county tax. Maryland State Comptroller of the Treasury v. Blanton, 390 Md. 528, 890 A.2d 279 (2006).

[9] Maryland State Comptroller of Treasury v. Wynne, 431 Md. 147, 64 A.3d 453 (Md. 2013).

[10] 431 Md. Ct. 160-161, 64 A.3d at 460–461.

[11] 430 U.S. 274, 97 S. Ct. 1076 (1977).

[12] For a discussion of the lower court opinions discussing Complete Auto and the dormant Commerce Clause, see Williamson and Hobbs, Does the Constitution's Dormant Commerce Clause Limit a State's Power to Tax Its Resident? Maryland v. Wynne, 56 Tax Mgmt. Memo. 3 (Jan. 12, 2015), and Fadel, May States Double Tax Their Residents' Income?, 68 Tax Law. 367 (2015).

[13] Although not an issue in this case, the fair apportionment requirement of Complete Auto also requires "external consistency," i.e., the tax must actually re ect a reasonable sense of the appropriate proportions to the business transacted in a state relative to other states. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169–170 (1983). External consistency examines whether "the economic justi cation for the state's claim upon the value taxed to discover whether a state's tax reaches beyond that portion of value that is fairly attributable to activity within the taxing state." Oklahoma Tax Commission v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995). See generally Hellerstein, et al., State Taxation, 3d ed. ¶4.16[2].

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Clause, the Court held that these precedents “all but dictate the result reached by Maryland’s highest court” in finding Maryland’s tax scheme unconstitutional.[26] Specifically, the Court relied upon three cases where the potential of double taxation of income earned outside the state of residency discriminated in favor of intrastate over interstate economic activity in violation of the Commerce Clause.

In J.D. Adams Mfg. Co. v. Storen,[27] Indiana taxed the worldwide income of every Indiana resident, including the out-of-state sales of the petitioner, an Indiana corporation. Ruling the tax regime violated the dormant Commerce Clause, the Court found that the “vice of the statute” was that it taxed without appor-

Oklahoma Tax Commission v. Jefferson Lines, Inc.,[41] the Court described the test as follows:

> Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear. This test asks nothing about the economic reality reflected by the tax, but simply looks to the structure of the tax to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with intrastate commerce. A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one state would place interstate commerce at the mercy of those remaining states that might impose an identical tax.[42]

Noting the use of this test in at least seven other Supreme Court cases over the last three decades,[43] the Court found the virtue of the test to be that it allows the judiciary to distinguish tax schemes that, in fact, discriminate against interstate commerce from tax policies that are not discriminatory but may nevertheless result in double taxation simply due to the different incentives offered by separate tax regimes.[44] To illustrate a nondiscriminatory tax scheme that might result in double taxation, the Court cited *Moorman Manufacturing Co. v. Bair*[45] where Iowa's single-factor sales formula for imposing its income tax did not violate the Commerce Clause despite the operation of most states' three factor formula of property, payroll and sales. The Court stated:

> The only conceivable constitutional basis for invalidating the Iowa statute would be that
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other states, the Court emphasized that Maryland could comply with the dormant Commerce Clause in other ways.[49] Thus, Maryland could render its scheme internally consistent (despite continuing to deny resi-

jority's wholehearted adoption of the internal consistency test in *Wynne* makes clear that the doctrine will be the standard for judging whether future state and local taxes discriminate against interstate commerce.

Finally, the dissent pointed out that the double taxation which the internal consistency test is intended to prevent would be satisfied if Maryland repealed its tax on nonresidents earning income in Maryland, a result that would still subject the Wynnes to double tax.[58]

> Example: State A taxes its residents on their worldwide income but does not tax nonresidents on their State A income. State B taxes its residents only on their State B income but still taxes nonresidents on their State B income. While both state's tax schemes are internally consistent, the tax burden on April and Bob in the prior example remain unchanged. April, a resident of State A, would pay a 1.25% tax only once to State A. Bob would still pay a 1.25% tax to State A where he resides and a 1.25% tax where he earns the income.

The example above illustrates that the internal consistency test can be met not by lowering Bob's taxes or raising April's taxes, but by eliminating the taxes imposed on some third taxpayer (say, Cathy).[59] This approach, argues the dissent, hardly cures the discrimination intended by the internal consistency test.

In sum, the dissent acknowledged the dormant Commerce Clause to be part of the Constitution, but believed its application in this case was incorrect. Finding the majority's reliance on *J.D. Adams*, *Gwin White & Prince*, and *Central Greyhound Lines* incorrect and citing *Shaffer*, *West Publishing* and *American Trucking* to find Maryland tax scheme not in violation of the dormant Commerce Clause, the dissent ultimately concludes the issue to be one of policy best left to the state legislatures and Congress, not the judiciary.

SCALIA DISSENT

While joining the principal dissent to demonstrate the incompatibility of the majority opinion with prior dormant Commerce Clause cases, Justice Scalia (joined in part by Justice Thomas) filed a separate dissent to declare the dormant Commerce Clause to be nothing more than a "judicial fraud" invented by courts to set aside state laws that they believe impose too great a burden on interstate commerce.[60] The fundamental problem with the dormant Commerce Clause, in Justice Scalia's opinion, is that the Commerce Clause "says nothing about prohibiting state laws that burden commerce."[61]

Acknowledging the doctrine has been part of the Court's interpretation of the Commerce Clause for over 100 years, Justice Scalia declared that age alone is not an excuse for "brazen invention."[62] In Justice Scalia's view only the Import/Export Clause[63] and the Duty of Tonnage Clause[64] impose direct limitations on the ability of the states to impose taxes under the Constitution. The Commerce Clause only empowers Congress to prohibit taxes that may burden interstate commerce and does not authorize the judiciary to set aside state taxes that it deems too burdensome.

The consequence of such judge made law is a "bestiary" of ad hoc tests and exceptions, such as the internal consistency rule, which bear no resemblance to anything in the Constitution's text, structure or other legal traditions.[65] Because no principle anchors the doctrine, Justice Scalia finds it to be unstable and incompatible with the role of the judiciary, compelling the Court to balance the needs of commerce against the needs of state governments, a task the Constitution assigns to the legislature, not judges.[66]

In Justice Scalia's view, rather than this "ad hocery," Congress could prescribe uniform national rules to address the problem of multiple taxation. The Court's creation of an internal consistency test to avoid double taxation in a hypothetical world where all states adopt the same internally consistent tax, does not reflect the real world where different states adopt different internally consistent taxes. Thus, if Maryland imposes its income tax on people who live in Maryland regardless of where they work (one internally consistent scheme), while Virginia imposes its income tax on people who work in Virginia regardless of where they live (another internally consistent scheme) Marylanders who work in Virginia remain subject to double taxation.

Nevertheless, after condemning the "Synthetic Commerce Clause" to be incompatible with the role of the judiciary, Justice Scalia concludes he will adhere to it under the doctrine of *stare decisis* but only when a state tax discriminates on its face against interstate commerce or cannot be distinguished from a tax which the Court has already held unconstitutional. In this case Maryland's law is not facially discrimina-

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[58] *Wynne* at 1822.

[59] Id. at 1823.

[60] Id. at 1807. The majority points out that this "fraudulent" doctrine has been applied in dozens of the Court's opinions, joined by dozens of Justices. *Id.* at 1806.

[61] Id. at 1808.

[62] Id.

[63] "No State shall, without the consent of Congress, lay any imposts or duties on imports or exports. . ." U.S. CONST. Art. I §10 cls. 2.

tory and reflects a decision made by the state legislature not to grant a credit against its tax; a policy decision, in Justice Scalia's view, the Constitution does not prohibit.[67]

THOMAS DISSENT

Finally, Justice Thomas did not join the principal dissent, rather writing his own opinion (joined in part by Justice Scalia) to declare the dormant Commerce Clause to have no basis in the Constitution and calling for complete reversal of the doctrine. Looking to the Framers' intent, Justice Thomas found no indication that they believed the Commerce Clause should in any way restrict the ability of states to tax their residents. Responding to Justice Alito pointing out that the Framers were unaware that some day it would be commonplace for a taxpayer to live in one state and work in another,[68] Justice Thomas points out that in deference to duly enacted laws of a state, particularly those concerning the pradigmatically sovereign activity of taxation, the burden of proof should fall on those who would use the Constitution to overturn them.[69]

MARYLAND'S REACTION TO DECISION

With its statute ruled unconstitutional, Maryland must now refund an estimated $201.6 million of tax, including $25,000 to the Wynnes, as well as interest on those refunds dating back as far as the 2006 tax year.[70] In addition, the ruling will reduce future local county tax revenue by approximately $43 million annually, $24.2 million from Montgomery County alone.[71]

Anticipating the Court's decision, Maryland's General Assembly in April passed the Budget Reconciliation and Financing Act of 2015[72] directing the Attorney General to inform the Comptroller of Maryland whether *Wynne* invalidates the practice of not allowing residents a credit against the county tax for out-of-state income taxes. Accordingly, upon release of *Wynne* on May 18, the Attorney General on May 29, wrote the Comptroller that the decision, in fact, mandates refunds.[73] The Attorney General's letter added that the Supreme Court did not prescribe what action the state must take in response to its decision, but noted the Court did state Maryland "could cure the problem with its current system by granting a credit for taxes paid to other states."[74] Therefore, upon the issuance of the Attorney General's letter, the Act automatically amended Maryland's law to provide for the credit,[75] and the Comptroller was instructed to draw amounts for the payment of refunds and interest from existing reserves, with subsequent recoupment of these amounts from the counties.[76]

With respect to the interest paid on such refunds, the General Assembly previously acted in 2014 to reduce the standard 13% interest rate on refunds, instructing the Comptroller to set the annual interest rate for *Wynne* related income tax refunds at a percentage (rounded to the nearest whole number) equal to the "average prime rate of interest quoted by commercial banks to large businesses during fiscal year 2015, based on a determination by the Board of Governors of the Federal Reserve Bank,"[77] i.e., approximately 3%. Changing the interest rate retroactively on refunds dating back almost a decade for such a specific group of taxpayers is likely to spawn further litigation at the local level.[78]

To assist Marylanders seeking refunds, the Comptroller's Office issued guidance in the form of frequently asked questions.[79] First, for the approximately 10,000 taxpayers[80] who filed protective claims to keep the statute of limitations open pending resolu-

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[67] *Id.* at 1811.

[68] The majority opinion states: "We are unaware of records showing, for example, that it was common in 1787 for workers to commute to Manhattan from New Jersey by row boat or from Connecticut by stage coach." *Id.* 1807.

[69] *Id.* at 1813.

[70] Springuel, *Letters Clear Way for Maryland Tax Refund Under High Court 'Wynne' Ruling*, 109 Daily Tax Rep. H-2 (June 8, 2015).

[71] Springuel, *'Wynne' Ruling Prompts Maryland County Budget Cutting*, 2015 Tax Mgmt. Weekly State Tax Rep. 10 (July 17, 2015).

[72] Md. H.B. 72 (2015).

[73] Letter of Attorney General Brian E. Frosh to Peter V.R. Franchot, Comptroller of Maryland, May 29, 2015.

[74] *Id.*, quoting *Wynne* at 1806.

[75] Md. H.B. 72 §4 and §26 (2015), amending Md. Code Ann. Tax-Gen §10-703. Section 4 provides for a credit against the local tax for taxes paid to another state, assuming the total allowable credit is not used against the state tax. Section 26 states that §4 only becomes effective if the *Wynne* decision invalidates Maryland law only permitting a credit against the state tax.

[76] *Id.* Section 27 provides that the state's reserve fund be used to pay *Wynne* refunds and requires the counties to reimburse the state based on each county's proportionate share of the refunds issued. For jurisdictions that do not reimburse the reserve fund the Comptroller is to withhold the reimbursement ratably over the next nine quarterly income tax distributions those localities receive from the state.

[77] Md. S.B. 172 (2014), amending Md. Code Ann. Tax-Gen §13-604.

[78] In a letter to then Maryland Governor Martin O'Malley dated May 14, 2014, then Attorney General Douglas Gansler stated that the limited application of the reduced interest rate is constitutional and legally sufficient because the Maryland Court of Appeals has stated on numerous occasions that the entitlement to interest on a tax refund is a matter of grace which can only be authorized by

tion of the case,[81] the Comptroller will process the refund requests with no further action required by taxpayers.

Others seeking a refund must le an amended return attaching a newly created Form 502LC (State and Local Tax Credit for Income Taxes paid to Other States and Localities) to calculate the credit offsetting the county tax. Amended returns must be led within the normal statute of limitations period, i.e., three years from the time a return was led or two years from the time the tax was paid, whichever is later.[82] A separate claim must be led for each year a refund is requested. Thus, an individual who previously led a Maryland individual income tax return (Form 502) would in addition to an amended return (Form 502X) attach a revised credit form (Form 502CR) and the new Form 502LC. If a credit is being claimed for taxes paid to more than one state or locality, a separate Form 502LC must be completed for each state or locality, as well as a summary Form 502LC totaling the state and local credits being claimed. The Comptroller's guidance makes clear that the credit is available for income taxes paid to local jurisdictions in other states, as well as the income tax paid to other states.

IMPACT OF DECISION UPON OTHER STATES

In making clear that to be constitutional a state's tax must be internally consistent, the Court in Wynne takes a step forward in distinguishing the permissible exercise of tax sovereignty from impermissible tax discrimination. Most recently, the Court on October 13, 2015, granted certiorari in First Marblehead Corporation v. Massachusetts Commissioner of Revenue[83] regarding whether the state's nancial institution excise tax violates the dormant Commerce Clause. However, the Court promptly vacated and remanded the case back to the Supreme Judicial Court of Massachusetts for further consideration in light of Wynne. Massachusetts denied Marblehead the ability to apportion certain purchased loan portfolios to a state other than Massachusetts for purposes of computing its property factor in deriving its Massachusetts tax base. While the Massachusetts high court applied the internal consistency test to determine if the tax violated the dormant Commerce Clause, it concluded there was internal consistency simply because there was no double taxation. Wynne now makes clear that the internal consistency test requires a hypothetical replication of the Massachusetts tax in every state, a test that goes beyond whether actual double taxation results from the tax in question.

While the Due Process Clause does not forbid multiple taxation of personal income, the dormant Commerce Clause prohibits multiple taxation unless the tax is internally consistent, a test met by most states through the grant of a credit for out-of-state income tax conditioned upon the other state granting a similar credit for their residents, i.e., reciprocity.[84] Credit is only granted with regard to income taxed in both states and the credit is limited to the lesser of out-of-state tax or the resident state's tax on the out-of-state income.[85]

However, there are many states and counties that do not grant a dollar-for-dollar credit to their residents for all income taxes paid in other jurisdictions. An amicus brief in Wynne led by the International Municipal Lawyers Association cite the following examples:

- Wisconsin and North Carolina both provide credits for state-level nonresident income taxes but not credits for city, county and local income taxes imposed on nonresidents;
- In 2011, the Tennessee Court of Appeals denied a credit for income taxes paid to South Carolina by a Tennessee resident on Subchapter S income reasoning that Tennessee and South Carolina did not have tax reciprocity;[86]
- Massachusetts disallows any deduction for out-of-state gross receipt taxes paid;
- Nonresidents of Pennsylvania cannot credit against the Philadelphia earnings tax income taxes paid to any other state or political subdivision;
- Ohio municipal income taxes provide no credit
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time be a resident in his or her state of domicile, potentially exposing the person to tax on his or her worldwide income in both states. New York addresses this problem by granting a credit to a dual resident if the other state of residency does not grant such a credit to its residents.[88] But if the other state also