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Maryland's Partial Tax Credit Scheme Held Unconstitutional in *Wynne*

On May 18, 2015, the U.S. Supreme Court, in *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. ___ (2015), in a 5-4 decision, affirmed past dormant Commerce Clause jurisprudence and reinvigorated the internal consistency test, holding that Maryland's personal income tax scheme violated the dormant Commerce Clause. The Court held that Maryland's tax system was unconstitutional because it failed to provide a full credit for taxes paid by residents for income earned in another state, while at the same time imposing a "special nonresident tax" on income earned in Maryland by nonresidents. In other words, the Court held that a state cannot have it both ways: it may not impose tax on all of its residents' income earned everywhere *and* on nonresidents' income earned in the state without also providing its residents with a full credit for taxes they have paid to other states under a source-based taxing regime.

Maryland's Personal Income Tax Scheme

Maryland imposes a personal income tax on its residents in two ways: (1) a "state" income tax and (2) a "county" income tax.[1] The state provides a credit to residents who pay income tax to another state for income earned outside of Maryland against the "state" tax, but it provides no credit against the "county" tax for taxes to other states or counties.[2] Nonresidents who earned income from sources within Maryland must pay the "state" income tax as well as a "special nonresident" tax.[3]

Facts

In 2006, Maryland residents Brian and Karen Wynne owned stock in Maxim Health Services, Inc., a Subchapter S corporation. That year, the Wynnes earned income through Maxim and filed tax returns in 39 states other than Maryland. The Wynnes claimed a state income tax credit for income taxes paid to other states on their Maryland return, and they also claimed a credit against the county portion of their taxes (though none was allowed by statute). The Maryland State Comptroller of the Treasury denied their claim to the credit against county taxes and assessed a tax deficiency, and the Wynnes appealed.

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1 Md. Tax-Gen. Code Ann. §§ 10-103, 10-105(a), 10-106.

2 Md. Tax-Gen. Code Ann. § 10-703.

3 Md. Tax-Gen. Code Ann. §§ 10-105(d), 10-106.1, 10-210.

The Hearings and Appeals Section of the Comptroller's Office and the Maryland Tax Court affirmed the assessment, but the Circuit Court for Howard County reversed on the grounds that the Maryland tax scheme violated the dormant Commerce Clause. The Court of Appeals of Maryland affirmed. The U.S. Supreme Court granted certiorari, and it also held that Maryland's personal income tax scheme violated the dormant Commerce Clause.

The Court's Decision

Perhaps the most striking aspect of the Court's decision is the vehement disagreement evident among Justices regarding the purpose and scope of the dormant Commerce Clause and the meaning of past Supreme Court precedent. The majority first traced the "deep roots" of the dormant Commerce Clause, noting that "[b]y prohibiting States from discriminating against or imposing excessive burdens on interstate commerce without congressional approval, [the dormant Commerce Clause] strikes at one of the chief evils that led to the adoption of the Constitution, namely, state tariffs and other laws that burdened interstate commerce." Under the dormant Commerce Clause, the Court noted that a state may not "impose a tax which discriminates against interstate commerce either by providing a direct commercial advantage to local business, or by subjecting interstate commerce to the burden of 'multiple taxation.'"

The Court then highlighted three dormant Commerce Clause precedents—*J.D. Adams Mfg. Co. v. Storen,*[4] *Gwin, White & Prince, Inc. v. Henneford*[5] and *Central Greyhound Lines, Inc. v. Mealey*[6] (all of which were decided prior to 1950)—and found that they dictated the result in this case. In each of those cases, the Court struck down a state tax scheme that resulted in the multiple taxation of income earned out of the state and discriminated in favor of intrastate over interstate economic activity. The majority then launched into what feels like a see-saw between an exposition of its own reasoning and a refutation of the dissenting opinions filed by Justices Scalia, Thomas, Ginsburg and Kagan.

The Commerce Clause Does Not Impose Different Rules for Individuals and Corporations

The comptroller first attempted to distinguish *J.D. Adams, Gwin* and *Central Greyhound* on the grounds that those cases concerned the taxation of corporations rather than individuals. The majority, however, rejected this argument and held that the dormant Commerce Clause should not treat individuals less favorably than corporations, explaining that multistate corporations benefit from state services just as much as individual residents. Accordingly, the Court rejected the suggestion that the dormant Commerce Clause rules that apply to corporations doing business in interstate commerce might not apply to individuals earning income in interstate commerce. Furthermore, the Court noted that it was disingenuous for the comptroller to argue that this was a case about "individual" taxation, since the income at issue was a type of corporate income (Subchapter S corporation pass-through income). The Court refused to adopt the comptroller's argument, since it would lead to the untenable outcome that C corporations receive greater protection under the dormant Commerce Clause than other businesses—including a large number of small businesses—that operate through pass-through entities.

The Court next turned to the principal dissent's related argument that individuals should be treated differently because individuals—unlike corporations—are Maryland voters. The majority likewise rejected this position, writing that "if a State's tax unconstitutionally discriminates against interstate commerce, it is invalid regardless of whether the plaintiff is a resident voter or nonresident of the State." The Court refuted the dissenters' supposition that residents would be

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4 304 U.S. 307 (1938).

5 305 U.S. 434 (1939).

6 334 U.S. 653 (1948).

able to seek relief through the ballot box, since only a minority of a state's residents are likely to earn material income from other states—meaning that legislators may tune out the small number of affected taxpayers' complaints if they view it as advantageous to the state to impose a discriminatory tax scheme.

The Commerce Clause and the Due Process Clause Impose Distinct Limits on State Taxation

The principal dissent also claims that the Commerce Clause imposes no limits on Maryland's ability to tax the income of its residents. The Court's majority explained, however, that this argument confuses what a state may do without violating the Due Process Clause of the Fourteenth Amendment and what it may do without violating the Commerce Clause. As numerous Commerce Clause cases point out, a state may, "consistent with the Due Process Clause, have the authority to tax a particular taxpayer"; nevertheless, such a tax must still satisfy the limitations imposed under the Commerce Clause.[7]

Thus, the *Wynne* decision stands for the proposition that while states do have the right to impose tax on the entirety of their residents' income, that right is limited by the dormant Commerce Clause's virtually per se rule barring discrimination against interstate commerce.

The Maryland Scheme Lacked Internal Consistency

The Court's majority explained the scope and application of those limits on states' ability to tax their residents through its discussion of the application of the "internal consistency" test, which is a measure adopted by the Court to evaluate whether a state taxing scheme impermissibly burdens interstate commerce by asking whether taxpayers would be subject to multiple taxation if every state were to impose an identical tax. By considering a taxing scheme through that lens, the internal consistency test allows the Court to "isolate the effect of a defendant State's tax scheme" to determine whether the tax scheme is "inherently discriminatory" against interstate commerce without regard to the tax schemes or policies of other states.

In *Wynne*, the Court noted that Maryland's scheme imposed tax on three separate sources of tax:

(1) Income earned by residents within the state;

(2) Income earned by residents outside the state; and

(3) Income earned by nonresidents of Maryland from Maryland sources.

Under such a system, the majority held, a state *must* provide for a credit for taxes paid to other states. Otherwise, the Court held, interstate commerce would be subjected to a higher burden of taxation than purely intrastate commerce if all states applied the same scheme.[8]

The Wynnes themselves provide the perfect example of this outcome, as they earned income in Maryland and a number of other states, and they paid tax to those other states where it was earned. Had Maryland provided a *full* credit for the taxes that the Wynnes paid to other states, then there would have been no risk of multiple taxation because the Wynnes would have paid tax on no more than 100 percent of their income (some to other states and some

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7 *Quill Corp. v. North Dakota*, 504 U.S. 298, 305 (1992); *see Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 580-583 (1997); *see also, e.g., Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994) (separately addressing due process and Commerce Clause challenges to a tax); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) (same).

8 *See Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. ___, 21-22 (2015).

to Maryland). However, the failure to provide full credit for taxes paid means that a portion of the Wynnes' income was taxed by other states (where it was earned) and taxed again by Maryland—while at the same time, Maryland was imposing full taxation on income earned by nonresidents within the state. Conversely, had the Wynnes earned the same amount of income entirely within the state of Maryland, none of their income would have been subject to multiple taxation. Thus, the Maryland scheme represented a quintessential violation of the internal consistency test, and the majority held that the scheme was in violation of the dormant Commerce Clause.

Maryland's scheme failed the internal consistency test because if all states applied the same scheme, then taxpayers doing business in interstate commerce would be taxed on more of their income than taxpayers doing business purely in intrastate commerce—which, in the majority's words, amounts to "discrimination" against interstate commerce.[9] The majority emphasized, however, that multiple taxation is constitutionally acceptable, so long as it results from the interplay of *otherwise fairly apportioned taxing schemes* rather than internally inconsistent schemes. This distinction explains the court's insistence that the Maryland scheme could be "cured" either by providing for a full credit for taxes to other states or by eliminating the credit altogether in conjunction with eliminating the tax on income earned by nonresidents in the state. In contrast to Maryland's partial-credit scheme, either of those alternatives would not result in multiple taxation if imposed by all states.

Alston & Bird Observations on the Decision

Monday's decision invalidated Maryland's scheme of taxation, which provided only a partial credit for tax paid by residents on income earned in other states. Contrary to what many outlets and practitioners are reporting, it is important to recognize that the decision does *not* require a full credit for taxes paid to other states; rather, what *Wynne* held is that a state may not have its cake and eat it too by:

- Fully taxing the income of its residents;
- Providing no credit (or less-than-full credit) for taxes paid to other states; *and*
- Taxing the income of nonresidents sourced to the state.

The fact that (according to the majority) Maryland's unconstitutional scheme can be "cured" by (1) providing no credit for taxes paid to other states while also (2) eliminating its tax on income earned by nonresidents within the state caused the dissenting Justices considerable heartburn. "How," they suggested, "can a 'discriminatory' taxing scheme be made less discriminatory if it is made even worse for resident taxpayers by stripping them of *any* credit?"[10] The answer lies in the very nature of the internal consistency test: as explained in *Container Corp*. and other Supreme Court jurisprudence applying this fair apportionment analysis, internal consistency does not focus on how any particular taxpayer or group of taxpayers *actually fares* in comparison to other taxpayers under a state's tax scheme, but whether the scheme, if applied everywhere—i.e., in a *hypothetical* universe—would place "interstate commerce" as a whole at a disadvantage.[11] The Supreme Court also clarified that it did not concede that the tax in *American Trucking* failed internal consistency; rather, the Court explained that all it conceded was that "if all States [adopted a similar tax], an interstate truck would have to pay fees totaling several hundred dollars, or even several thousand

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9 *See, e.g., id.* at 24.

10 *Id.* at 16-17 (Ginsburg, J., dissenting) ("Maryland could, in other words, bring itself into compliance with the test at the heart of the Court's analysis without removing the double tax burden the test is purportedly designed to 'cure.'"). Justice Ginsburg added in a footnote a criticism of the majority's conflation of the phrases "inherent discrimination" and "internal inconsistency." *Id.* at 17 n.10.

11 *See Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983); *see also, e.g., Armco, Inc. v. Hardesty*, 467 U.S. 638, 642 (1984).

dollars, were it to 'top off' its business by carrying local loads in many (or even all) other States." This statement by the Court is important since the holding in *American Trucking* called into question the scope and viability of the internal consistency analysis and this arguably adds some clarification to that decision. While the decision was obviously hotly contested among the nine Justices, the 5-4 majority opinion re-affirms the essentially per se rule barring discrimination against interstate commerce. For multistate businesses, this means that they will continue to have an important judicial protection against state laws that impose a higher rate or burden of taxation on out-of-state businesses. It also may have important implications for states' growing use of their alternative apportionment powers, as the opinion forcefully affirms that the effect of a state's taxing scheme may not be to discriminate against interstate commerce, regardless of the number of taxpayers that are actually discriminated against.

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