Another Wynne for Taxpayers: Unconstitutional Limitations on Credits For Taxes Paid to Other States

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In Comptroller of the Treasury of Maryland v. Wynne, the U.S. Supreme Court declared Maryland’s income tax credit scheme unconstitutional, holding that the state’s failure to provide a full credit for the state and local taxes paid to other states was internally inconsistent and, therefore, violated the dormant Commerce Clause. The taxpayers in Wynne were a married couple who were shareholders in an S corporation that operated in 39 states. While Maryland provided a credit against other state income taxes paid by the Wynnes, such credits did not apply against Maryland’s county income taxes, thereby subjecting some of the Wynnes’ income to double taxation (first in the state where earned, and second in Maryland when it was subjected to the county tax). As the Court explained, Maryland’s scheme violated internal consistency because it imposed discriminatory treatment on certain resident taxpayers “solely” because they earned income “interstate.”

This article focuses on a similar tax credit issue, the constitutionality of which seems highly suspect in light of the holding and reasoning of Wynne. Specifically, a number of states limit the amount of resident taxpayers’ credits for taxes paid to other states so that the credit is no more than the amount of tax that would have been due on the same income computed under the home state’s base and rate. These limitation provisions commonly result in a reduction of the amount of the credit that the home state will provide for the taxes paid to the other state; furthermore, they have the effect of imposing tax on residents at a higher rate than if all of the residents’ income had been earned within their state of residence—an unconstitutional result. This article explores the law and related guidance of just a few of the states that apply such a scheme. For ease of reference, I generally refer to these laws as “Credit Limitation Laws.”

2 The Court did not hold that a state must always provide a full credit for taxes paid to other states. Instead, it held that a full credit is required in a system like Maryland’s, in which the state imposes tax on all income earned by its residents everywhere, and also imposes a tax on all Maryland-sourced income earned by non-residents. Id. at 1804-05 (explaining that purely residence-based or source-based tax schemes are not discriminatory because any double taxation under such schemes arises “only from the interaction of two different but nondiscriminatory tax schemes”). Virtually every state in the country utilizes the same hybrid source/residency system at issue in Wynne.
3 Id. at 1803-04.
4 Of course, such laws also include a number of other qualifiers and requirements: for example, many states do not permit taxpayers to take a credit for income earned in another state unless that other state provides a reciprocal credit.
Alabama

A recent decision of the Alabama Tax Tribunal rejected the state’s Credit Limitation Law on state law grounds. The Alabama Department of Revenue’s credit regulation limits a taxpayer’s credit “to only the amount of tax that would have been due on the same income computed using Alabama’s tax rates.” After setting out an example applying that limitation, the Tribunal concluded that the result of applying the law was that “at least a part of an Alabama resident’s foreign-sourced income would be taxed by both Alabama and the foreign jurisdiction in which it was earned.” Accordingly, the Tribunal struck down the regulation, finding that it was inconsistent with the state credit statute, which applied to the amount of tax “actually paid” to another state, and which the legislature had passed with the explicit intent of eliminating double taxation.

Although the Alabama Credit Limitation Law was struck down for being inconsistent with the state statute rather than on constitutional grounds, the reasoning of the Tribunal explains precisely why such a law is also unconstitutional: because its application leads to the discriminatory double taxation of interstate income based solely on where such income is earned. It is not clear whether or how the Alabama Department of Revenue will revise its credit regulation, but given the provision’s unconstitutionality, the state should not be able to resolve the situation by simply amending the statute to conform to the existing regulation.

California

California’s statutory credit for taxes paid to other states limits that credit to an amount not more than the amount of “net tax” that the same amount of income would have been subjected to under the laws of California. Schedule S to the individual income tax return provides the computation for this limitation to California’s credit, the result of which is that the California resident taxpayer must reduce his or her credit for taxes paid to any other jurisdiction that imposes tax at a higher rate than California would have imposed on the same income.

Virginia

Virginia has a regulation which provides that a taxpayer’s credit for taxes paid to another state is limited to the lesser of: (i) the tax actually paid to another state on non-Virginia source income; or (ii) the amount of tax actually paid to another state which is equivalent to the proportion of income taxable in such state to Virginia taxable income (computed prior to the credit).

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6 Id. at *1.
7 Id. at *3.
8 Id. at *2-3 (citing State v. Robinson Land & Lumber Co. of Alabama, Inc., 77 So. 2d 641 (Ala. 1955)).
10 For better and for worse, there aren’t too many such states.
The regulation provides an example of the result that obtains from application of this limitation provision:

**EXAMPLE 1:** Taxpayer A, a Virginia resident, has taxable income of $25,000 derived from the operation of a sole proprietorship business in State W, upon which tax is paid to State W in the amount of $1,750. A's Virginia taxable income is $50,000, resulting in a tax liability, before computation of the credit, of $2,655. A may claim a credit for tax paid to State W of $1,327.50 computed as follows:

\[
\text{Income on which tax computed in State W} = \frac{$25,000}{\text{Virginia taxable income}} = \frac{$25,000}{$50,000} = 50% \\
\text{Ratio (above) x Va. tax liability} = 2,655 \times 50\% = $1,327.50 \\
\]

Since the amount computed proportionally is less than the tax actually paid to State W, the credit is limited to $1,327.50.\(^{12}\)

The department's regulation demonstrates the unconstitutionality of the provision, for the taxpayer in question would have owed $2,655 in taxes if all its income were earned in Virginia during the year. Because half of the income was earned in another state, however, the taxpayer owed $1,327.50 to Virginia and $1,750 to State W, for a total tax liability of $3,077.50.

**Louisiana**

Louisiana provides a credit for taxes paid to another state, if the other state provides a similar credit for taxes paid to Louisiana on income earned from Louisiana sources.\(^{13}\) But such credit is limited as follows: “The credit is limited to the amount of Louisiana income tax that would have been imposed if the income earned in the other state had been earned in Louisiana.”\(^{14}\) This language is another version of a Credit Limitation Law that yields the same unconstitutional result as in California and Virginia, for it explicitly reduces the credit for taxes paid to another state on interstate business as if such income were earned intra-state. As in *Wynne*, this limitation on the credit for taxes paid to other states has the potential to yield the (unconstitutional) result of imposing tax on the taxpayer at a higher rate than would have applied had the taxpayer earned the same amount of income within Louisiana.

**West Virginia**

Finally, West Virginia’s provision for the computation of a credit for taxes paid to another state is similarly unconstitutional. The state regulation provides that “[t]he credit shall not reduce the West Virginia personal income tax otherwise due to an amount less than would have been due if the income subject to taxation by the other jurisdiction were excluded from the taxpayer's West Virginia income.”\(^{15}\) Though the language is somewhat inartful, the effect is the same as that which results from application of the other state laws discussed above: the other state credit must be reduced to the extent it is imposed on a higher tax base or rate than West Virginia would have applied to that portion of the taxpayer’s income.

\(^{12}\) *Id.*

\(^{13}\) *La. Rev. Stat. § 47:33(A)(5).*

\(^{14}\) *See* *La. Rev. Bulletin No. 16-052 (July 21, 2016).*

\(^{15}\) *W. Va. Code of State Rules 110-21-20.2(3).*
Thus, West Virginia’s Credit Limitation Law is a violation of internal consistency for the same reasons described above with respect to California, Virginia, Louisiana, and any other state that requires such a recomputation.

**Conclusion**

Under the holding and reasoning of *Wynne*, there is a compelling argument that the state laws that reduce a taxpayer’s credit for taxes paid to another state so that they do not exceed the tax that the state of residence would have imposed on the same amount are unconstitutional. Indeed, the Supreme Court in *Wynne* appeared to corroborate this conclusion, explaining that a tax scheme which imposes tax at a higher rate on income earned outside the state would violate internal inconsistency—which, as the Alabama Tax Tribunal showed, is precisely the effect of these limitation provisions.\(^\text{16}\) Because these unconstitutional Credit Limitation Laws cause a dollar-for-dollar increase in taxpayers’ liabilities to their states of residence, taxpayers and their advisers should consider this position when preparing or reviewing their returns in the future.

\(^{16}\) *Wynne*, 135 S. Ct. at 1805; *Moody*, 2016 WL 5867756, at *2-*3. It should be noted that a state could “save” the constitutionality of such provisions in multiple ways. For example, in addition to eliminating the credit limitation, a state could likely eliminate the discriminatory effect of such laws by “topping up” the amount of any credit for taxes paid to a state that imposes tax at a lower rate or on a narrower tax base.