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Multistate Tax
EXTERNAL ALERT

Supreme Court Rules Maryland Individual Income Tax Scheme Unconstitutional

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Overview

On May 18, 2015, the U.S. Supreme Court delivered a much anticipated decision in *Comptroller of the Treasury of Maryland v. Wynne* ("*Wynne*") in favor of the taxpayers.[1] The litigation focused on the constitutionality of the credit for taxes paid to other states as applied under Maryland's individual income tax regime, which is comprised of two components – a "State" income tax and a "County" income tax. In previous state-level litigation, the Maryland Court of Appeals (Maryland's highest court) had held that despite their labels, both the state and county components of the income tax were state-imposed taxes.[2] Under Maryland's regime, residents who earn income in other states may take a credit – based on income taxes paid to other states – against the "State" component of the Maryland tax but not against the "County" component.[3] In a 5-4 decision, the U.S. Supreme Court affirmed the decision of the Maryland Court of Appeals and held that this partial-credit scheme is unconstitutionally discriminatory and "operates as a tariff," thereby violating the dormant Commence Clause.[4]

In this Tax Alert we summarize the opinion of the U.S. Supreme Court and provide some taxpayer considerations.

Background

The taxpayers in *Wynne*, a married couple, are Maryland residents who earned income through a Maryland-based S corporation. A substantial portion of that income was earned from and taxed in jurisdictions outside of Maryland. On their 2006 Maryland individual income tax return, the taxpayers claimed credits against both their Maryland "State" and "County" tax for the tax amounts paid to other states. On audit, the Comptroller determined that the taxpayers had underpaid their 2006 state individual income taxes by improperly claiming a credit against their "County" tax[5] and issued a deficiency assessment. The taxpayers appealed, claiming that the partial-credit regime was unconstitutional. The Maryland Tax Court held for the Comptroller, validating the partial-credit regime. Holding in favor of the taxpayers, the Howard County Circuit Court reversed the Tax Court's decision.

The Maryland Court of Appeals affirmed the Circuit Court's decision and held that the Maryland tax regime is unconstitutional because it violates the dormant Commerce Clause under the U.S. Supreme Court's test in *Complete Auto Transit Inc. v. Brady*.[6] As part of its decision, the Maryland Court of Appeals remanded the case with instruction that the Tax Court "recalculate the Wynnes' tax liability in a manner consistent with this opinion."[7] The Comptroller subsequently petitioned the U.S. Supreme Court for a writ of certiorari to review the judgment of the Maryland Court of Appeals. The U.S. Supreme Court granted certiorari in 2014.[8]

U.S. Supreme Court Decision

Writing for the majority of the Court, Justice Alito began the opinion by reaffirming the importance of dormant Commerce Clause jurisprudence in preventing states from "discriminating against or imposing excessive burdens on interstate commerce without congressional approval."[9] This affirmation stands in sharp contrast to the view of

[1] *Comptroller of the Treasury of Maryland v. Wynne*, No. 13-485, (Alito, J., opinion of the Court) (U.S. May 18, 2015).
[2] *See*, *Frey v. Comptroller of Treasury*, 29 A.3d 475, 492 (Md. 2011).
[3] Md. Code Ann., Tax-Gen. § 10-703(a).
[4] No. 13-485, slip op. at 22, (Alito, J., opinion of the Court) (U.S. May 18, 2015).
[5] Md. Code Ann., Tax-Gen. § 10-703(a) provides that a resident may claim a credit only against the "State" component of the income tax.
[6] *Comptroller of the Treasury of Maryland v. Wynne*, 431 Md. 147, 165 (2013).
[7] *Id.* at 178.
[8] *Id.*, cert. granted, 134 S. Ct. 2660 (2014).
[9] No. 13-485, slip op. at 5 (Alito, J., opinion of the Court).

Justices Scalia and Thomas as expressed in a dissenting opinion (one of three dissenting opinions filed in the case) authored by Justice Scalia wherein they refer to the dormant Commerce Clause as "a judicial fraud."[10]

The Dormant Commerce Clause, an Overview

The Commerce Clause grants Congress the power to "regulate Commerce . . . among the several States."[11] Although the Commerce Clause is framed as a positive grant of power to Congress, the Court has "consistently held this language to contain a further, negative command, known as the dormant Commerce Clause, prohibiting certain state taxation even when Congress has failed to legislate on the subject."[12] As explained by the Court in *Wynne*, "[b]y prohibiting States from discriminating against or imposing excessive burdens on interstate commerce without congressional approval, it 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."[13] The "dormant Commerce Clause precludes States from 'discriminat[ing] between transactions on the basis of some interstate element'"[14] or taxing "a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State."[15]

Maryland's Regime is Discriminatory

In upholding the Maryland Court of Appeals decision, the Court's five-justice majority first concluded that "existing dormant Commerce Clause cases all but dictate the result in this case by Maryland's highest court."[16] Specifically, the Court cited three cases in which it had struck down state tax schemes that "might have resulted in the double taxation of income earned out of the State and that discriminated in favor of intrastate over interstate economic activity."[17] Although each of these cases involved the imposition of gross receipts taxes on corporate taxpayers, as opposed to the net income taxes imposed on individuals, the Court held "we have now squarely rejected the argument that the Commerce Clause distinguishes between taxes on net and gross income."[18] Further, with respect to the distinction between individual and corporate taxpayers, the Court stated, "it is hard to see why the dormant Commerce Clause should treat individuals less favorably than corporations."[19]

The Court reasoned that by only allowing "partial" credit (*i.e.*, credit against the "State" portion of the tax) for income taxes paid by residents to other states on income earned from those other states, Maryland's individual income tax scheme thereby discriminated in favor of intrastate over interstate economic activity. The Court based this reasoning on the application of the "internal consistency" test.[20]

The internal consistency test "looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate."[21] The Court explained:

> By hypothetically assuming that every State has the same tax structure, the internal consistency test allows courts to isolate the effect of a defendant State's tax scheme. This is a virtue of the test because it allows courts to distinguish between (1) tax schemes that inherently discriminate against interstate commerce without regard to the tax policies of other States, and (2) tax schemes that create disparate incentives to engage in interstate commerce (and sometimes result in double taxation) only as a result of the interaction of two different but nondiscriminatory and internally consistent schemes.[22]

Applying this test, the Court concluded that if every state adopted Maryland's scheme, income earned by individuals from outside their state of residence would be taxed at a higher rate than income earned from intrastate

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[10] No. 13-485, slip op. at 2 (Scalia, J., dissenting).
[11] U.S. Const. art. I, § 8, cl. 3.
[12] *Oklahoma Tax Comm'n* v. *Jefferson Lines, Inc.*, 514 U.S. 175, 179 (1995).
[13] No. 13-485, slip op. at 5 (Alito, J., opinion of the Court), citing *Fulton Corp.* v. *Faulkner*, 516 U.S. 325, 330–331 (1996); *Hughes v. Oklahoma*, 441 U.S 322, 325; *Welton* v. *Missouri*, 91 U.S. 275, 280 (1876); *see also*, The Federalist Nos. 7, 11 (A. Hamilton), and 42 (J. Madison).
[14] No. 13-485, slip op. at 5-6 (Alito, J., opinion of the Court); citing *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318, 332, n. 12 (1977).
[15] No. 13-485, slip op. at 5-6 (Alito, J., opinion of the Court); citing *Armco Inc.* v. *Hardesty*, 467 U.S. 638, 642 (1984).
[16] No. 13-485, slip op. at 6 (Alito, J., opinion of the Court); citing *J. D. Adams Mfg. Co. v. Storen*, 304 U.S. 307 (1938); *Gwin, White & Prince, Inc. v. Henneford*, 305 U. S. 434 (1939); and *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948).
[17] No. 13-485, slip op. at 6-7 (Alito, J., opinion of the Court).
[18] *Id*. at 9.
[19] *Id*.
[20] *Id*. at 18-21.
[21] *Id.* at 18-19; citing *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.,* 514 U.S. 175, 185 (1995).
[22] No. 13-485, slip op. at 19 (Alito, J., opinion of the Court).

sources.[23] The Court continued by stating that, "[c]ritically . . . the Maryland scheme's discriminatory treatment of interstate commerce is not simply the result of its interaction with the taxing schemes of other States. Instead, the internal consistency test reveals . . . Maryland's tax scheme is inherently discriminatory and operates as a tariff."[24] The Court deemed this conclusion "fatal because tariffs are '[t]he paradigmatic example of a law discriminating against interstate commerce.'"[25]

The Court also answered Maryland's argument that there is no limit to a state's ability to tax its own residents by holding that, while Maryland may have the "raw power" to tax its residents' out-of-state income, that doesn't mean the state will not have to comply with the limitations under the dormant Commerce Clause.[26] The Court also reaffirmed that a tax may be constitutionally valid under the Due Process Clause but not meet the higher threshold of scrutiny under a Commerce Clause analysis.[27]

Based on foregoing, the Court affirmed the judgment of the Maryland Court of Appeals.[28]

Court Provides No Specific Remedy or "Rule of Priority"

In its opinion, the Supreme Court stopped short of providing a specific remedy for the discrimination found in Maryland. The Court specifically refused to establish a "rule of priority" as to which state would have to yield to another, where one taxed on the basis of residence and the other on source.[29] Instead, the Court reasoned that "while Maryland could cure the problem with its current system by granting a [full] credit for taxes paid to other States, we do not foreclose the possibility that it could comply with the Commerce Clause in some other way."[30] The Court clarified this position by noting,

> Whenever a State impermissibly taxes interstate commerce at a higher rate than intrastate commerce, that infirmity could be cured by lowering the higher rate, raising the lower rate, or a combination of the two. For this reason, we have concluded that "a State found to have imposed an impermissibly discriminatory tax retains flexibility in responding to this determination."[31]

Considerations

Although it remains to be seen how Maryland will remedy the discriminatory provision, Maryland residents with income sourced in other states and who did not claim a credit (for taxes paid to those other states) against the "County" component of their Maryland taxes may wish to consider filing refund claims for open tax years based on the holding in *Wynne*. As for the approximately 8,000 protective refund claims that have already been filed, it has been reported that estimated refunds would total at least $202 million.[32]

Taxpayers anticipating or filing for refunds should also recall that in May 2014 Maryland adopted provisions retroactively reducing the interest rate on potential refunds arising specifically from this case.[33] This special rate was set well below the 13 percent state statutory rate for tax refunds, to a rate that is equal to "the average prime rate of interest quoted by commercial banks to large businesses" in fiscal 2015, currently 3.25 percent.[34] Now that *Wynne* has been decided in favor of the taxpayers, it is possible that this retroactive statutory change could be challenged.

While the decision may potentially have implications outside Maryland, it is important to remember that this decision specifically pertains to Maryland, which has a state-imposed "County" tax that was precluded from relief from multiple taxation. The decision does not necessarily stand for the proposition that every state with localities that impose an income tax must grant to its residents a credit against the local portion of the tax for taxes paid to other states. Rather, this decision follows the dormant Commerce Clause doctrine, confirms its application to individual residents engaged in interstate business, applies the internal consistency test, and leaves to the states

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[23] *Id.* at 22-23.
[24] *Id.* at 22.
[25] *Id.;* citing *West Lynn Creamery, Inc. v. Healy,* 512 U.S. 186, 193 (1994).
[26] No. 13-485, slip op. at 13 (Alito, J., opinion of the Court).
[27] *Id.;* citing *Quill Corp. v. North Dakota,* 504 U.S. 298, 305 (1992).
[28] No. 13-485, slip op. at 28 (Alito, J., opinion of the Court).
[29] *Id.* at 25.
[30] *Id.*
[31] *Id.* at 26; citing *McKesson Corp. v. Div. of Alcoholic Beverages and Tobacco,* 496 U.S. 18, 39–40 (1990). Note that the Court discussed this remedy issue in response to arguments made in the principal dissent. No. 13-485, slip op. at 25-26 (Alito, J., opinion of the Court).
[32] Jennifer DePaul, *Maryland Counties Owe Millions in Tax Refunds Under Wynne Decision*, Tax Analysts, May 19, 2015.
[33] S.B. 172, 2014 Leg., 431st Sess. (Md. 2014).
[34] *Id*.

the “flexibility in responding” to a determination that a state has “imposed an impermissibly discriminatory tax.” In other words, each discrimination case must be evaluated based on its own set of facts and circumstances, both as to the discrimination asserted by the taxpayer and the particular taxing scheme at issue.

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