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Constitutional Limitations

Maryland v. Wynne has garnered a lot of attention recently and is arguably one of the most important state tax cases to be heard by the U.S. Supreme Court this year. In this article, Maryland attorney Alexandra Sampson discusses the potential implications of the *Wynne* case and how the impact of the court's opinion could extend beyond individuals and pass-through entities and reach corporate multistate businesses.

Why Corporate Taxpayers Should Care About 'Wynne'

By Alexandra E. Sampson

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Maryland State Comptroller of the Treasury v. Wynne[1] has received quite a bit of attention in the state tax community because, well, let's be honest—the high court doesn't take a lot of state tax cases. However, the corporate tax community has taken what might appear to be a passive interest in the case as it involves what many would consider a one-state nuance—Maryland's two-tier individual income tax scheme for state residents.

However, the U.S. Supreme Court briefing in *Wynne* and, certainly, the line of questioning from the justices during oral argument (and the responses by counsel for the parties) bring to light a number of issues that could be addressed in the court's opinion in the case that would impact all multistate businesses—pass-through

[1] 64 A.3d 453 (Md. 2013), *cert. granted* 134 S. Ct. 2660, No. 13-485 (2014).

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entities and C corporations alike. This is a case that every state taxpayer should be watching.

Background

The facts of the case revolve around Maryland's unique two-part individual income tax scheme for state residents.[2] Under that scheme, Maryland imposes a state income tax, the rate for which is dependent on the taxpayer's income, and a county income tax, the rate for which depends on the county where the taxpayer resides.[3] Maryland residents may claim a credit against the state portion of Maryland's tax on income earned out of state, but not the county portion.[4]

During the tax year at issue, Maryland residents Brian and Karen Wynne held shares in an S corporation—Maxim Healthcare Services, Inc.—that generated income that passed through to the Wynnes. Maxim is a multistate business and a substantial portion of the Wynnes' distributive share of Maxim's income had been generated in states other than Maryland and had been subject to tax in the states where earned for the year at issue. In filing their Maryland return, the Wynnes claimed their *pro rata* share of Maxim's income taxes paid to other states as a full credit against their Maryland individual income tax liability. The Comptroller's office limited the credit for taxes paid to other states to the amount of Maryland state income tax paid by the Wynnes, while not allowing a credit against the county income tax paid, and issued an assessment for the resulting deficiency.

Although the Maryland Tax Court ruled in favor of the Comptroller, the Maryland Circuit Court for Howard County reversed that decision and held that the state's failure to allow a credit against the county portion of the tax violated the dormant commerce clause. The Maryland Court of Appeals (Maryland's highest court) affirmed the judgment of the Circuit Court. The state filed a petition with the U.S. Supreme Court, which the court granted. The Supreme Court heard oral arguments last month.

Why Should Corporate Taxpayers Care About 'Wynne'?

At first blush, this case involves a unique individual income tax scheme that has no parallels for corporate tax purposes. After all, there's no question that under current U.S. Supreme Court jurisprudence C corporations are protected, at least in principle, from discriminatory and double taxation under the dormant commerce clause.

However, whether the high court decides to side with the state or the Wynnes in this case, taxpayers can expect to see some discussion of the dormant commerce clause. As the linchpin of state taxation, any case impacting the dormant commerce clause should be closely watched by multistate corporate taxpayers. Based upon the briefing and oral argument, I've identified a few potential commerce clause implications of the court's opinion, as well as a couple of potential non-income tax implications, if Maryland is victorious.

Potential Commerce Clause Implications

Clarification of the Internal Consistency Test? One issue at the heart of the *Wynne* case is whether Maryland's individual income tax scheme fails the fair apportionment prong of the four-part test articulated in *Complete Auto Transit, Inc. v. Brady*.[5] In order for a tax to be fairly apportioned—and survive commerce clause scrutiny—it must be internally consistent.[6] ''To be internally consistent, a tax must be structured so that if every state were to impose an identical tax, no multiple taxation would result.''[7]

The parties in *Wynne* disagree on how to apply the internal consistency test to the state's individual income tax and credit scheme.[8] Counsel for the Wynnes argues that if every state adopted Maryland's tax scheme, interstate commerce would be subjected to multiple taxation nationwide.[9] That's because, in addition to Maryland's two-part tax on the income of Maryland residents, the state also imposes a special tax on the income of nonresidents who earn income within the state.[10]

> Thus, if every state adopted Maryland's tax scheme, income earned by residents out of state would be taxed twice: once by the state of the income's source, and again by the state of the taxpayer's residence. And residents would receive only partial credit for taxes owed out of state, creating double taxation. Maryland's scheme is thus internally inconsistent,

[2] No other state has an individual tax scheme quite like Maryland's. That is, no other state denies a full credit for taxes paid to other states.

[3] See Md. Code Ann., Tax-Gen §§10-102, 10-103(a), 10-105, 10-106. It's important to note that although the Maryland tax scheme has a ''state'' and ''county'' portion, both are considered state taxes. *See Frey v. Comptroller of Treasury*, 29 A.3d 475, 492 (Md. 2011).

[4] Md. Code Ann., Tax-Gen. §10-703(a).

[5] 430 U.S. 274, 279 (1977) (where the court outlines that a state tax will satisfy the commerce clause if it ''is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.'' *Id.* at 279).

[6] *See Goldberg v. Sweet*, 488 U.S. 252, 261 (1989); *see also Okla. Tax Comm'n v. Jefferson Lines*, 514 U.S. 175, 185 (1995) (''For over a decade now, we have assessed any threat of malapportionment by asking whether the tax is 'internally consistent...' ''). The tax must also be externally consistent to meet the fair apportionment prong, but external consistency was not raised as an issue in the U.S. Supreme Court briefing or oral argument in *Wynne*. However, the Maryland Court of Appeals did determine that the operation of the county tax appeared to create external inconsistency. *See Comptroller of Treasury v. Wynne*, 64 A.3d 453, 467 (Md. 2013).

[7] *Goldberg*, 488 U.S. at 261.

[8] In predicting that the court may shed additional light on the internal consistency test, I assume, as an initial matter, that the court will determine that the same commerce clause protections C corporations enjoy are also due to individual owners of pass-through entities (which is also an issue in the case). Should the court disagree, which would likely signal a decision in favor of the state, it won't need to address the internal consistency issue, or many of the other issues outlined in this article.

[9] *See Brief for Respondents* at 21, *Comptroller of the Treasury of Maryland v. Wynne*, No. 13-485 (U.S. September 2014).

[10] *See* Md. Code Ann., Tax-Gen. §10-106.1.

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because adoption of an identical scheme by every other state would 'add [a] burden to interstate commerce that intrastate commerce would not also bear.[11]

Maryland, however, takes the position that the internal consistency test should only be applied when two states impose tax on the same income on the same basis. That is, ''when two taxes are imposed on the same value based on distinct jurisdictional rationales, it's not impermissible double taxation under the commerce clause.''[12] Thus, under the state's position, there's no internal consistency problem when, as in this case, one state taxes income on the basis of situs and another state taxes the same income on the basis of source.

The court's opinion will likely clarify how the internal consistency test should be applied. If the court sides with the state and takes the position that the internal consistency test should be applied only when two states tax the same value on the same jurisdictional basis, it could significantly narrow the application of the internal consistency test. For example, consider gains from the sale of real property. Would the state's ''same jurisdictional basis'' approach mean that in the corporate income tax context it would be permissible for such gains to be allocated entirely to the state where the property is located and also apportioned to other states? How about income from insurance premiums? Would it be acceptable for one state to tax all of an insurance company's premium receipts, while another state included the same premiums in an apportioned net income? Finally, would it call into question the sales and use tax credit regime?[13] That is, would a use tax credit for sales tax paid on an item or transaction in another state no longer be required because, arguably, the state imposing a use tax is imposing a tax based on a different jurisdictional rationale than the state imposing a sales tax?

On the other hand, if the court agrees with the taxpayer and upholds the commonly understood application of the internal consistency test, it doesn't necessarily mean that the taxpayer will prevail. In *American Trucking Associations, Inc. v. Michigan Public Service Commission*[14], the court sustained a flat tax that it acknowledged was not internally consistent.[15]
If the court were to take this approach, it could signal a further weakening, if not complete abandonment, of the internal consistency test, which could have a devastating impact on future commerce clause cases involving corporate taxpayers.

A New or Expanded Dormant Commerce Clause Exception? During briefing and oral argument the state raised, and a number of the justices seemed to be concerned with, the issue of fairness.[16] That is, if the court rules in favor of the taxpayer and requires a full credit for both the state portion and county portion of the state income tax,

> ''[a] Maryland resident earning all of her income in other states might have no obligation to pay any Maryland income tax at all . . ., [but] would still be entitled to claim all the advantages of residence by sending her children to Maryland public schools or applying for various forms of public assistance that are reserved for Maryland residents.''[17]

The state argues that ''[i]t is hard to discern the justification for imposing a constitutional requirement that would compel states to accommodate residents who prefer to accept the benefits of residency while avoiding the corresponding responsibilities.''[18] As irrelevant as

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[11] *See Brief for Respondents at 21-22*. To illustrate this point, Respondents include the following example in their brief:

> Assume every state has adopted Maryland's scheme, imposing a 4.75 percent ''state'' income tax on residents and nonresidents alike, in addition to a 1.25 percent ''county'' income tax on residents and an equivalent 1.25 percent ''special nonresident tax'' on nonresidents. John resides in Home State and earns an income of $200,000, all within Home State. His total income-tax burden—owed entirely to Home State—will be $12,000, calculated by multiplying $200,000 by the overall Home State income-tax rate of 6 percent. Like John, Mary resides in Home State and has an income of $200,000. But unlike John, Mary engages in interstate commerce. Although she earns half her income in Home State, she earns the other half in Neighboring State. Absent any apportionment, she will owe $12,000 to Home State, calculated by multiplying her total income of $200,000 by the overall Home State income-tax rate of 6 percent. She will also owe $6,000 to Neighboring State, calculated by multiplying her Neighboring State income of $100,000 by the overall Neighboring State income-tax rate of 6 percent. Home State, however, will credit her for only the ''State'' portion of the taxes on her Neighboring State income—which amounts to $4,750, or $100,000 multiplied by 4.75 percent. So Mary's total income-tax burden will be $13,250—$7,250 owed to Home State and $6,000 owed to Neighboring State. As this example shows, Mary ends up owing $1,250 more in taxes than John, just because she does business across state lines. That added burden results from the double taxation of Mary's income earned in a different State. And because that burden falls on interstate commerce alone—without affecting intrastate commerce at all—the tax is not internally consistent. *Id.* at 22-23.

[12] Transcr. of Oral Arg. at 24-25, lines 24-25 and 1-2, *Comptroller of the Treasury of Maryland v. Wynne*, 13-485 (Nov. 12, 2014).

[13] Taxpayers with a use tax liability in one state are generally given a credit for sales tax legally paid to another state with respect to that same item or transaction.

[14] 545 U.S. 429 (2005) (''*American Trucking – Michigan*'').

[15] In *American Trucking – Michigan*, Michigan imposed a flat $100 annual fee on trucks engaged in intrastate commercial hauling. The taxpayers challenged the fee as discriminatory because trucks that carried both interstate and intrastate loads engage in intrastate business less than trucks that confine their operations within the state. Thus, the flat fee fell more heavily on interstate carriers. In upholding the fee, the court acknowledged that

> Petitioners add that Michigan's fee fails the
>
> 'internal consistency' test . . . . We must concede that here, as petitioners argue, if all States did the same, an interstate truck would have to pay fees totaling several hundred dollars, or even several thousand dollars, were it to 'top off' its business by carrying local loads in many (or even all) other states. *Id.* at 437-438.

[16] *See Brief for the Petitioner*, at 23-24, *Comptroller of the Treasury of Maryland v. Wynne,* No. 13-485 (U.S. July 2014); Transcr. of Oral Arg. at 29-30, lines 16-25 and 1-17.

[17] *Brief for the Petitioner*, at 23-24.

[18] *Id.* at 24.

this may seem to the ultimate question of whether Maryland's income tax credit scheme violates the dormant commerce clause, the notion that a state may be excused from structuring its taxes in such a way as to avoid a constitutional infirmity is not new.

Over the years we've seen the court depart from established dormant commerce clause jurisprudence to carve out exceptions. One such exception is for functions that are typically and traditionally government functions. In *United Haulers Association, Inc. v. Oneida-Herkimer Solid Waste Management Auth.*,[19] the court upheld an ordinance that required delivery of all solid waste to a publicly owned and operated local facility, at the exclusion of out-of-state facilities. Subsequently, in *Department of Revenue v. Davis*[20] the court upheld a Kentucky tax scheme that exempted interest earned on local public bonds but taxed interest earned on bonds issued by other states. In both cases, the statutory schemes clearly discriminated against interstate commerce, yet the court determined that the schemes concerned government functions—waste management and the financing of government—which ''may be directed toward any number of legitimate goals unrelated to [simple economic] protectionism.''[21] These cases, along with others,[22] signal a tolerance by the court of certain dormant commerce clause violations that are considered to be incidental or de minimis, particularly where certain public benefits provided by state governments outweigh any arguable burdens.

Could *Wynne* present another opportunity for the court to further limit the scope of the dormant commerce clause? Specifically, could the court determine that in order for Maryland's discriminatory taxing scheme to constitute a dormant commerce clause violation, the harm caused by the discrimination must be substantial in comparison to the benefits[23] received or bestowed upon Maryland residents by the state? If it does so decide, what would it mean for corporate taxpayers seeking to prove a commerce clause violation? Historically, the court has not recognized a de minimis exception for burdens on interstate commerce.[24] Would a state win mean that taxpayers would be required to show not only that a particular state tax fails the four-part test under *Complete Auto*, but also that there's some undue burden on interstate commerce? Stated differently, would the court grant Justice Scalia's wish[25] by substantially weakening the role of *Complete Auto* in the dormant commerce clause by adding a ''de minimis burden'' exception?

Goodbye Dormant Commerce Clause? At least two justices—Justice Scalia and Justice Thomas—have rejected the notion of a dormant commerce clause.[26] In fact, during oral argument in *Wynne*, Justice Scalia referred to the dormant commerce clause as the ''imaginary negative commerce clause.'' Further, Chief Justice Roberts has previously expressed some skepticism about the dormant commerce clause.[27] Taking the opposite view, Justice Alito and Justice Kennedy have generally been champions of the dormant commerce clause.[28] With at least two newer members of the court that could go either way on the doctrine's place in the Constitution—Justices Kagan and Sotomayor—could we see a complete departure from the court's historic view of the dormant commerce clause? I admit that this is a highly unlikely result, but the court's opinion, and any concurring or dissenting opinions, might signal a reworking of dormant commerce clause doctrine and signal its ultimate fate.

Other Potential Implications

In addition to the dormant commerce clause implications, the *Wynne* decision could have implications for business outside the income tax context and could impact credit regimes around the country.

Corporate tax departments could also find themselves scrambling to decipher how to apply the already complex withholding tax rules to employees working in

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[19] 550 U.S. 330 (2007).

[20] 128 S. Ct. 1801 (2008).

[21] *United Haulers*, 550 U.S. at 343.

[22] *See e.g.*, *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456 (1981) (where court determined that a statute imposing a ban on plastic nonreturnable milk containers imposed an incidental burden on interstate commerce that was not clearly excess in relation to the putative local benefits.).

[23] Counsel for the State of Maryland noted that these benefits include ''public schools, social services programs, medical assistance services, and of course the right to vote in the process that determines both the level of these benefits and the level of taxes that are paid in return for them.'' Transcr. of Oral Arg. at 3, lines 15-19.

[24] *See Fulton Corp. v. Faulkner*, 516 U.S. 325, 334 n.3 (1996) (''[W]e have never recognized a 'de minimis' defense to a charge of discriminatory taxation under the commerce clause.''); *see also Associated Indus. of Missouri v. Lohman*, 511 U.S. 641, 649-50 (1994) (''Under our cases, unless one of several narrow bases of justification is shown, actual discrimination, wherever it is found, is impermissible, and the magnitude and scope of the discrimination have no bearing on the determinative question whether discrimination has occurred.''(*citation omitted*)).

[25] *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 201 (1995) (Scalia, J., concurring) (''I look forward to the day when *Complete Auto* will take its rightful place. . .among the other useless and discarded tools of our negative commerce clause jurisprudence.'').

[26] *See e.g., Tyler Pipe Industries v. Department of Revenue,* 483 U.S. 232, 263 (1987) (Scalia, J., concurring in part and dissenting in part) (where Justice Scalia notes that ''the historical record provides no grounds for reading the commerce clause to be other than what it says – an authorization for Congress to regulate commerce.'' *Id.* at 263); *United Haulers*, 550 U.S. 330, 348 (2007) (Scalia, J., concurring) (where Justice Scalia writes separately to reaffirm his view that ''the so-called 'negative' commerce clause is an unjustified judicial invention...''); *United Haulers*, 550 U.S. at 349 (Thomas, J., concurring) (where Justice Thomas concurs in judgment and notes that ''[t]he negative commerce clause has no basis in the Constitution and has proved unworkable in practice.''); *Kentucky*, 128 S. Ct. at 1821-1822 (Thomas, J., concurring) (where Justice Thomas notes that ''rather than apply a body of doctrine that 'has no basis in the Constitution and has proved unworkable in practice,'' he ''would entirely 'discard the court's negative commerce clause jurisprudence.' '' (*citation omitted*)).

[27] *See United Haulers*, 550 U.S. at 354 (where Chief Justice Roberts delivered the opinion of the court and noted that '''the dormant commerce clause is not a roving license for federal courts to decide what activities are appropriate for state and local government to undertake. . . .' ''(*citation omitted*)).

[28] *See e.g., United Haulers*, 550 U.S. at 356-371 (Alito, J., dissenting); *C&A Carbone, Inc. v. Town of Clarkstown, N.Y.*, 511 U.S. 383 (1994) (where Justice Kennedy delivered the opinion of the court determining that a local ordinance violated the dormant commerce clause).

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multiple states should the state prevail. Specifically, calculating the amount of income tax to be withheld from the wages of an employee who works in multiple states that do not have reciprocity with the employee's state of residence could become murkier, particularly if jurisdictions in addition to Maryland begin to impose limits on their tax credit schemes.

Conclusion

No matter which way the court comes out in this case, its decision will likely impact and explain the court's interpretation of the dormant commerce clause. Further, a state win in the case could have implications for corporate taxpayers in other contexts. Needless to say, if *Wynne* is not on your case watch list, I hope you're penciling it in now.

The U.S. Supreme Court will issue a decision in *Wynne* before the end of the current term, which concludes June 2015. Due to the complexity of the issues in the case, we don't expect to see a decision before early 2015.

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