

FEATURED NEWS

U.S. Supreme Court Strikes Down Maryland's Income Tax Regime

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In a 5-4 decision, the U.S. Supreme Court on May 18 affirmed a Maryland Court of Appeals ruling that the state's personal income tax scheme violates the U.S. Constitution's dormant commerce clause.

Brian and Karen Wynne are Maryland taxpayers who received income from an investment in an out-of-state S corporation. The couple challenged the state's denial of a full credit for taxes paid to other states on income passed through from their investment.

Maryland granted a full credit on the state income tax but granted no credit against the county income tax, which is also collected by the state. The Wynnes challenged the denial of the county credit as a violation of the commerce clause and won in state court. The state appealed to the U.S. Supreme Court. (Prior coverage: *State Tax Notes*, Nov. 17, 2014, p. 367.)

"Clearly this was an internally inconsistent tax," Walter Hellerstein, a law professor at the University of Georgia, told Tax Analysts. "I'm thrilled internal consistency is alive and well, because one vote on the other side [and] you would have had [Justice Antonin] Scalia saying internal consistency is a bunch of garbage."

Joe Huddleston of the Multistate Tax Commission, however, was disappointed by the decision. "I think the majority missed some of the points that I would have liked them to focus on, and I'm sorry they returned to the dormant commerce clause as their fundamental justification," he said.

In its decision, written by Justice Samuel A. Alito Jr. and joined by Chief Justice John G. Roberts Jr. and Justices Anthony Kennedy, Stephen G. Breyer, and Sonia Sotomayor, the Court said that its precedent cases have consistently invalidated a state tax scheme that might have resulted in double taxation of income earned out of the state and favored intrastate over interstate economic activity.

"Our existing dormant commerce clause cases all but dictate the result reached in this case by Maryland's highest court," the Court said, adding that "Maryland admits that

its law has the same economic effect as a state tariff, the quintessential evil targeted by the dormant commerce clause."

The majority rejected the argument that prior cases dealt with gross receipts taxes, not net income taxes, and thus do not apply in this context. "We see no reason why the distinction between gross receipts and net income should matter," the Court wrote, adding that proper analysis should focus on the practical effects of the tax rather than the formal language in the tax statute.

The Court also rejected the dissent's claims that prior cases have dealt with corporate rather than individual income taxation, saying that "it is hard to see why the dormant commerce clause should treat individuals less favorably than corporations."

Bruce Ely of Bradley Arant Boult Cummings LLP said, "The majority opinion does a good job of basically emasculating the dissent," adding that "it gives you a birds-eye into the Court's thinking, and of course helps us understand why it took so long for the Court to issue this ruling."

"I think Justice Sotomayor, since she's had limited experience on the Court, nobody really had enough background from her," Steve Wlodychak of EY said. "But I think by signing on with the majority here, she demonstrated a firm understanding of the constitutional principles in the tax world."

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The majority opinion rejected the argument that individuals are less protected by the dormant commerce clause because they receive many services from the government. It said that like residents, corporations also benefit heavily from state and local services. Also, the Court said, the right of individuals to vote does not change the decision because "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 said that while the due process clause of the 14th Amendment may allow a state to tax all of the income of its residents, even income earned outside the taxing jurisdiction, it does not mean it satisfies the commerce clause.

"The due process clause does not trump the commerce clause, and powers a state has to tax residents under the former must also satisfy the latter. Alito also makes clear that

Thurgood Marshall's erroneous dictum in *Goldberg v. Sweet* cannot be taken seriously," said professor Richard Pomp of the University of Connecticut School of Law.

"Although the principal dissent claims the mantle of precedent, it is unable to identify a single case that endorses its essential premise, namely, that the commerce clause places no constraint on a State's power to tax the income of its residents wherever earned," the Court wrote.

The Court said that a critical factor was that Maryland's discriminatory tax regime is not the result of its interaction with the taxing scheme of other states. "Instead, the internal consistency test reveals what the undisputed economic analysis shows: Maryland's tax scheme is inherently discriminatory and operates as a tariff," the Court said. It added that the resident state does not have to recede to a state taxing based on source.

"Maryland could remedy the infirmity in its tax scheme by offering, as most states do, a credit against income taxes paid to other states," the Court said, adding "if it did, Maryland's tax scheme would survive the internal consistency test and would not be inherently discriminatory."

The Court added, however, "We do not decide the constitutionality of a hypothetical tax scheme that Maryland might adopt because such a scheme is not before us. That Maryland's existing tax unconstitutionally discriminates against interstate commerce is enough to decide this case."

Dissenting Opinion

Justice Ruth Bader Ginsburg — joined by Scalia and Justice Elena Kagan — authored a dissent, saying that the majority's opinion veers from the Court's well-established principle as stated in the 1995 case *Oklahoma Tax Comm'n v. Chickasaw Nation*, that "a nation or state 'may tax all the income of its residents, even income earned outside the taxing jurisdiction.'"

While the majority opinion distinguished *Chickasaw Nation* as a due process clause case, Ginsburg wrote that the principle that a state may tax all of its residents' income without restriction from other states' source-based taxes has been, until this case, confirmed by the Court consistently and voluminously. The real issue in the case, she said, was about policy choices and whether a state favored taxing all of its residents the same or preventing the incidence of double taxation.

"As I see it, nothing in the Constitution or in prior decisions of this Court dictates that one of two States, the domiciliary State or the source State, must recede simply because both have lawful tax regimes reaching the same income," Ginsburg said.

"I think the dissent was very well written and that Justice Ginsburg made those points in terms of when and how states can tax," Huddleston said. "In some circumstances, they may not be the best public policy determinations to make, but it's appropriate for states to make those calls, not the Court."

"Kagan and Ginsburg have no fault with the dormant commerce clause," Karl Frieden of the Council On State Taxation said. Frieden said Ginsburg's dissent says that when a resident-state tax conflicts with a source-state tax, both should be given equal weight and that the issue should be left to the legislature.

"Whether we like it or not, congressional action often picks winners and losers, but that's the structure we have adopted. I think it's unfortunate when we find the courts picking winners and losers," Huddleston added.

What's Next?

Jeff Friedman of Sutherland Asbill & Brennan LLP said the *Wynne* decision shouldn't cause much upheaval in state tax systems across the country.

"Because Maryland was so out of step with the rest of the country, that this was such a rare occurrence that a credit was not provided for taxes paid to other states, we will not see any upheaval in personal income taxation," he said. "Had this behavior been running rampant, we would see an upheaval, but it wasn't — Maryland was an outlier. And that was something that the majority noted."

Huddleston was not sure about that, though. "I think there will be continuing impact of this decision as to how individuals are taxed all over the country and whether they will have to meet the standards the Court has adopted for corporations, and we'll see what that means in other jurisdictions," he said.

Huddleston added that he is not sure that the Maryland income tax regime is as unusual as the majority seemed to think. "I know the majority said that, but there are any number of other states that have similar statutes to this, whether it's Kentucky [which] has exemptions in the area of municipal bonding or whether it's . . . Missouri and Oklahoma, [which] have substantially identical statutes. There are probably other states that have similar kinds of restrictions on where and how they give credits for income earned in other states," he said.

Local governments filed an amicus brief saying *Wynne* may have implications and that there are many states with long-established tax programs like Maryland's that do not afford dollar-for-dollar credits to residents for all out-of-state income taxes paid.

That brief identified Wisconsin and North Carolina as states that do not allow a credit against local income taxes, as well as a number of local governments that fail to provide a credit for state taxes paid against local taxes, including Philadelphia; Cleveland; Detroit; Indiana's counties; Kansas City, Missouri; St. Louis; and Wilmington, Delaware.

"For Maryland and other states with similar regimes, this decision will cause impacted taxpayers to file claims for refund for prior tax periods that remain open under the statute of limitations," Katina Peterson of Dorsey & Whitney LLP said. She said that the refund claims are projected to be close to \$200 million in Maryland. ☆