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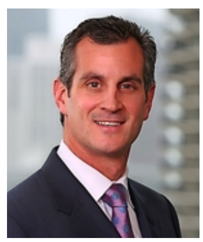
Constitutional Limitations

Because of its roots in the dormant commerce clause and the internal-consistency test, *Comptroller v. Wynne* may have a country-wide impact. In this article, Anthony Dick, Charolette Noel and Mark Rotatori of Jones Day discuss the decision and its potential implications, not only for Maryland, but also for states with similar tax schemes.

'Comptroller of the Treasury of Maryland v. Wynne': What Are the Potential Consequences?





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Introduction

On May 18, 2015, in *Comptroller of the Treasury of Maryland v. Wynne*, the U.S. Supreme Court held that Maryland's personal income-tax scheme violated the dormant commerce clause.[1] The Maryland tax scheme was found to be comparable to other unconstitutional tax schemes that had the potential to result in discriminatory double taxation of income earned out of state, that created a powerful incentive to engage in intrastate rather than interstate economic activity and

[1] *Comptroller of Treasury of Maryland v. Wynne*, 135 S. Ct. 1787 (2015).

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that were not cured by satisfying the ''internal consistency'' test.

Wynne involved a challenge to the joint operation of two components of Maryland's personal income tax: the ''state'' income tax (Md. Tax-Gen. Code Ann. §10-105(a)) and the ''county'' income tax (§§10103, 10106). Maryland residents who paid personal income tax in another jurisdiction received a credit against Maryland's ''state'' tax for taxes paid to those other jurisdictions, but they did not receive a credit against the ''county'' tax. Additionally, nonresidents who earned income within Maryland paid both the ''state'' income tax and an additional ''special nonresident tax'' in lieu of the ''county'' tax.

The Wynnes challenged these aspects of Maryland's personal income tax as violations of the commerce clause because, as a result of the Maryland tax regime, they were double-taxed on certain portions of their income—once by the state in which it was earned and a second time in Maryland, which did not provide a full credit to offset the out-of-state tax. The Wynnes argued that this double-taxation scheme discriminated against interstate commerce because it burdened interstate income more heavily than intrastate income, and thus incentivized Maryland residents to earn income within the state rather than across state lines.

The Decision

In a 5-4 decision,[2] the U.S. Supreme Court agreed, holding that Maryland's tax scheme violated the dormant commerce clause. The majority opinion, written by Justice Alito, found the tax scheme indistinguishable from certain corporate taxes that the U.S. Supreme Court had previously struck down. Like those invalidated corporate taxes, Maryland's personal income tax not only taxed income earned by nonresidents within its borders, but also taxed income earned by Maryland residents in other states, while refusing to give them a credit for the income taxes they paid in those other states. The court held that this tax scheme violated the dormant commerce clause because it ''had the potential to result in discriminatory double taxation of income earned out of state and created a powerful incentive to engage in intrastate rather than interstate economic activity.''[3] The court explained that it has ''long held that States cannot subject corporate income to tax schemes similar to Maryland's,'' and it saw ''no reason why income earned by individuals should be treated less favorably.''[4]

Four justices dissented in three separate opinions by Justices Scalia, Thomas and Ginsburg, whom Justices Scalia and Kagan joined. This lineup illustrates that although the court is sharply divided in dormant commerce clause cases, the division does not fall along traditional ideological lines. Justice Scalia's and Justice Thomas's main disagreement was not with the majority's application of precedent, but rather with the very notion that Constitution contains any ''dormant'' commerce clause at all. As Justice Scalia wrote in his dissent (joined in relevant part by Justice Thomas), ''[t]he fundamental problem with our negative Commerce Clause cases is that the Constitution does not contain a negative Commerce Clause. It contains only a Commerce Clause.''[5] Based on that view, Justice Scalia has repeatedly stated that he will apply the ''dormant'' commerce clause only for the sake of stare decisis, and will thus strike down laws only if they are completely indistinguishable from laws the court has previously invalidated. Justice Thomas has gone even farther, saying that he will not apply the dormant commerce clause at all.

By contrast, Justice Ginsburg's dissent (joined by Justices Scalia and Kagan) accepted the validity of the court's dormant commerce clause jurisprudence, but argued that Maryland's tax scheme should nonetheless survive. Although she recognized that Maryland's personal income-tax scheme bore some resemblance to corporate tax schemes previously struck down, she distinguished those cases on the ground that they involved gross receipts taxes rather than personal income taxes (a distinction that the majority rejected as irrelevant). Justice Ginsburg contended that Maryland's tax scheme must be upheld in order to respect the unconditional right of each sovereign state to tax the full income of its own individual residents, who receive unique benefits from their home state.[6]

In response to this last point, the majority answered that states *do* have the right to tax the full income of their residents, as long as their overall tax scheme does not discriminate against or unduly burden interstate commerce. Hence, the problem with Maryland's tax scheme was not simply that it taxed the full income of its residents, including income they earned out-of-state, but also that it taxed the income that *nonresidents* earned within Maryland, without providing any offsetting credit. Consequently, the majority explained, Maryland's tax scheme violated the ''internal consistency'' test, which the court had applied in at least seven previous dormant commerce clause tax cases.

The internal consistency test asks whether interstate and intrastate commerce would be taxed equally if every state were to adopt the precise tax scheme at issue. As Justice Alito explained in his opinion for the court, ''[b]y 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.''[7] As the Supreme Court has explained elsewhere, ''[a] failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction''[8] The bottom line is that if a state like Maryland wants to tax income earned by *nonresidents* within its borders, then it must give its *own residents* a credit for

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[2] Interestingly, within an hour after the Supreme Court heard oral arguments, this 5-4 decision was predicted at a panel discussion hosted by Council On State Taxation (COST), Bloomberg BNA and Jones Day. *See Special Report – Comptroller v. Wynne: Post Oral Argument Predictions and Analysis*, 34 Tax Management Multistate Tax Report, no. 12, Dec. 26, 2014, at S-7 (Expert Panel Makes Predictions and Analyzes Policy Implications About High Court Oral Arguments in 'Comptroller v. Wynne'), S-13 (Dormant Commerce Clause Foes Scalia and Thomas Likely to Side with Maryland Along with Kagan and Ginsburg, Panelists Say).

[3] *Id.* at 1801-1802.

[4] *Id.* at 1792.

[5] *Id.* at 1808 (Scalia, J., dissenting).

[6] *Id.* at 1814 (Ginsburg, J., dissenting).

[7] *Id.*, at 1802.

[8] *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).

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the taxes they pay in other states. Alternatively, if a state wants to tax the full income of its own residents, then it cannot tax the income of nonresidents. A state can choose one option or the other, but it cannot choose both. Because Maryland tried to choose both, its tax scheme violated the internal consistency test.[9]

Wynne is, thus, highly significant for its holding that internally inconsistent state personal income tax schemes violate the dormant commerce clause. This ruling goes a long way towards clarifying whether the credits that some states afford their residents for income taxes paid in other states are merely a matter of policy or a constitutional requirement. This decision breathes substantial new life into the internal consistency test, which, as Justice Ginsburg's dissent pointed out, had not been used to strike down a state tax law for nearly 30 years.[10] In the near term, the court's decision may have a serious economic impact on certain state and local governments, as well as taxpayers. Early estimates predict that Maryland will be responsible for approximately $200 million in tax refunds to over 55,000 Maryland taxpayers. Approximately $115 million of this amount is attributable to taxpayers in Montgomery County alone. In addition, several other states, including New York, Indiana, and Pennsylvania, have municipalities with similar tax schemes that might require overhaul in the wake of this decision.[11]

Remaining Questions

Several legal questions also remain as a result of the court's decision. For example, it is unclear how the holding in *Wynne* will affect municipalities that collect their own income taxes at the municipal level. Unlike Maryland, which levied its local taxes at the state level and then redistributed the local taxes to the localities, municipalities that collect their taxes at the local level could argue that they are not subject to the ''inter*state*'' commerce clause. It is also unclear whether the court's rejection of the argument that the commerce clause distinguishes between gross receipts taxes and income taxes—at least with respect to the discrimination standard—can be read to mean that the physical presence standard of nexus established in *Quill Corp.* should be consistently applied among different taxes.[12]

Further, the court did not decide how an offending state should remedy the constitutional defect in a tax scheme that fails the internal consistency test. The court emphasized that states retain flexibility in deciding how they will satisfy the test: States are not strictly required to provide their residents with tax credits for income earned in other states, as long as they do not tax income earned within their borders by nonresidents. States like Maryland must simply choose either to stop taxing nonresident income, or else give their resident taxpayers credit for income taxes paid in other states. The Constitution leaves it up to the states to make this choice of remedies, as long as they do not run afoul of other requirements such as ''fair apportionment'' or ''external consistency.''[13]

Because the internal consistency test respects federalism by allowing different states to make different choices as to the tax schemes they will adopt, it leaves room for the possibility that some double taxation may legitimately result from the overlap of two different state tax regimes, if those regimes are both internally consistent. So, for example, if Maryland taxed only income of its residents (but wherever earned) while Virginia taxed only income earned within its borders (but wherever the earner resided), then a Maryland resident earning income in Virginia would pay tax on that income to both states. Yet both states' tax schemes would be ''internally consistent.'' Accordingly, as this hypothetical shows, the mere fact of double taxation alone is not enough to show a constitutional violation under the dormant commerce clause. Nonetheless, this possibility may prove to be more hypothetical than real, since few jurisdictions refuse to provide credits for local residents who pay income taxes elsewhere.

[9] *Wynne*, 135 S. Ct. 1803-06.

[10] *Id.* at 1820-21 (Ginsburg, J., dissenting).

[11] *See generally,* Liz Farmer, *Supreme Court Ruling on Maryland's Double Income Tax Could Impact Other States and Localities*, Governing, May 19, 2015, *available at* http://www.governing.com/topics/finance/gov-supreme-court-maryland-income-tax.html.

[12] *Quill Corp. v. North Dakota*, 504 U.S. 298, 305 (1992), was cited favorably in *Wynne* for distinguishing when a state may have authority to tax a particular taxpayer consistent with the Due Process Clause but the imposition of such tax may nonetheless violate commerce clause requirements. Because the taxpayers in *Wynne* were residents of Maryland, sufficient nexus for taxation was not at issue in the case.

[13] *See generally* Bradley Joondeph, *Opinion Analysis: Maryland's Personal Income Tax Violates the Commerce Clause*, SCOTUSblog, May 19, 2015, *available at* http://www.scotusblog.com/2015/05/opinion-analysis-marylands-personal income-tax-violates-the-commerce-clause.