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Wynne wins

On May 18, 2015, the Supreme Court issued its decision in *Comptroller of the Treasury of Maryland v. Wynne* (No. 13-485). It is a victory for Brian Wynne and his wife – and other similarly situated Maryland residents. It could also have ramifications beyond Maryland's borders.

Background. Maryland residents currently pay state as well as county (or "local") income tax on all of their taxable income, regardless of its source; non-residents pay Maryland state income tax on income generated in Maryland, as well as a "special non-resident tax." Maryland's Comptroller collects the taxes, and distributes the county tax to the relevant county; the non-resident tax goes to the state's general fund. Residents with out-of-state "source" income that has been taxed in that other state can claim a credit for such tax against their Maryland *state*, but NOT county, income tax. *Wynne* involved this credit. Before getting into the case, some additional background on Maryland's income tax structure might be helpful:

- Initially, Maryland only had a state income tax.
- As of 1939, Maryland allowed a credit against a resident's state income tax for income taxes paid to another state on income generated in that other state.
- In 1967, Maryland mandated that its counties and the City of Baltimore impose a local income tax (the rate was up to the municipalities, subject to various limitations). Litigation arose over whether the credit also applied against this local tax. In 1974, the Maryland Court of Appeals held that it did, in *Stern v. Comptroller* (271 Md. 310).
- In early 1975 (presumably in response to *Stern*), Maryland enacted legislation providing that the credit only applied against the *state* income tax, and not the county or local income tax. Litigation arose over this limitation, which the Maryland Court of Appeals upheld in 2006, in *Comptroller v. Blanton*, on the basis of the "plain language" of the statute (390 Md. 528); no constitutional issues were raised.
- As of 2004, the special non-resident tax took effect; its rate matches the lowest county tax (1.25%). Litigation arose over whether this tax unconstitutionally discriminated against non-residents. In 2011, the Maryland Court of Appeals held that it did not, in *Frey v. Comptroller*; the court likened the tax to the

county tax that applies to residents, and affirmed that the county tax is in fact a "state" tax for constitutional purposes (422 Md. 111).

Phew! Now to *Wynne.*

The facts. Brian and Karen Wynne lived in Howard County, Maryland, with their five children. During 2006, Brian Wynne was the President of Maxim Healthcare Services, Inc., and one of its seven owners. Maxim had its headquarters in Howard County, and was an "S Corporation" for federal income tax purposes – meaning that its income "passed through" to its owners, and was not taxable to the entity. Because Maxim earned much of its income in states other than Maryland (it was a nationwide business), it filed income tax returns in 39 states: in states that recognized the Maxim's "S" status, Maxim filed "composite" returns on behalf of the shareholders (this way, the shareholders didn't have to file separately in the state, and were allocated a pro rata share of the state income tax Maxim paid on their behalf); in states that didn't recognize Maxim's S status, Maxim filed a separate corporate return. In 2006, the Wynnes had $2.67 million of taxable income (much of it from their 2.4% ownership in Maxim); through a combination of composite and corporate returns, the Wynnes paid their out-of-state taxes, which totaled nearly $85,000. The Wynnes claimed a full credit for these taxes, applying it to both their state and county tax which totaled, before credits, nearly $210,000.

The Comptroller denied the credit against the county tax, and issued an assessment for the resulting tax deficiency; the Wynnes appealed. The Appeals Section of the Comptroller's Office affirmed the assessment, with a slight adjustment. The Wynnes then appealed to the Maryland Tax Court, where they argued, for the first time, that limiting the credit to state tax discriminated against interstate commerce, in violation of the Commerce Clause. The Tax Court rejected that argument and affirmed the assessment in late 2009. The Wynnes appealed to the Circuit Court for Howard County, which reversed the Tax Court in July of 2011 (No. 13-C-10-80987). The Circuit Court held that limiting the credit to state income tax was indeed unconstitutional, and remanded the case to the Tax Court for further factual development and "an appropriate credit for out-of-state income taxes paid" on Maxim's income. An appeal to the Court of Special Appeals was noted; before that court heard the case, the Comptroller appealed to the Maryland Court of Appeals.

In early 2013, the Court of Appeals affirmed the Circuit Court, stating that while both the county income tax and the credit were constitutional, the application of the credit – "or lack thereof" – to the county income tax was not. The court noted that the credit previously applied to the county income tax, and "was only eliminated from the computation and application of the credit by a 1975 amendment of the tax code…that amendment, when applied to particular circumstances of taxpayers like the Wynnes…contravenes the Constitution." (431 Md. 147). The Comptroller appealed to the Supreme Court.

In a 5-4 decision, the Supreme Court affirmed the decision of the Maryland Court of Appeals, and held that Maryland's "personal income tax scheme" was unconstitutional. Justice Samuel Alito wrote the Court's opinion, which Justices John Roberts, Anthony Kennedy, Stephen Breyer and Sonia Sotomayor joined. Justices Antonin Scalia and Clarence Thomas filed separate dissenting opinions; Justice Ruth Bader Ginsberg filed a dissent, which Justices Scalia and Elena Kagan joined.

What Justice Alito said. In a nutshell, Justice Alito said that because Maryland does not offer a full credit for income taxes that residents pay to other jurisdictions for income "earned" within those other jurisdictions, some of that income can be taxed twice; because "Maryland's scheme creates an incentive for taxpayers to opt for intrastate rather than interstate economic activity," it violates the dormant Commerce Clause.

Time out: what is the "dormant Commerce Clause"? The Commerce Clause is found at Article I, Sec. 8, clause three of the Constitution. It provides that Congress has the power to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." In addition to being an express grant of Congressional authority, the clause has also come to mean (through case law) that states can't discriminate against interstate trade by, for example, imposing a tax that gives a direct commercial advantage to local business or subjects interstate commerce to "multiple taxation." This implicit command is known as the "dormant" (or negative) Commerce Clause.

Justice Alito analyzed some prior Supreme Court cases decided under the dormant Commerce Clause: these held that it was unconstitutional for a state to tax the out-of-state income of a resident corporation; why, he queried, should individuals have any less protection under that clause? He refuted the Comptroller's argument that because States provide their residents with many services, such as local roads, local police and protection and local public schools, they should have a free hand to tax their residents' out-of-state income; corporations, too, "benefit heavily" from state and local services, such as local roads to transport their goods, and local police and fire departments to protect their facilities. "Thus, disparate treatment of corporate and personal income cannot be justified based on the state services enjoyed by these two groups of taxpayers." And the Comptroller's "notion that the victims of such discrimination have a complete remedy at the polls is fanciful....It is even more farfetched to suggest that natural persons with out-of-state income are better able to influence state lawmakers than large corporations headquartered in the State."

Although the Constitution's Due Process Clause of the Fourteenth Amendment allows a State to tax *all* of a resident's income, even what is earned outside of the taxing jurisdiction, the State's imposition of the tax may still violate the Commerce Clause. Here, Maryland's tax scheme failed the "internal consistency" test. In other words, if every state did what Maryland did, and only gave a partial credit for out-of-state taxes, interstate commerce would be at a disadvantage compared to *intra*state commerce because that out-of-state income could be taxed twice. "Maryland's tax scheme is inherently discriminatory and operates as a tariff."

In response to the Comptroller's observation that Maryland receives less from residents who earn income from interstate, rather than intrastate, commerce, Justice Alito stated, "This argument is a red herring. The critical point is that the total tax burden on interstate commerce is higher, not that Maryland may receive more or less tax revenue from a particular taxpayer." While Maryland could cure the problem with its current system by granting a 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." The constitutionality of such a "hypothetical tax scheme that Maryland might adopt" was not before the Court, however. "That Maryland's existing tax unconstitutionally discriminates against interstate commerce is enough to decide this case."

Justice Scalia's dissent. Justice Scalia criticized the majority for invoking the "negative Commerce Clause," which he characterized as "a judge-invented rule" and a "judicial fraud" that allows judges to set aside state laws "*they believe* burden commerce" [italics in original]; he noted that there is no "negative" Commerce Clause in the Constitution, only the Commerce Clause. Justice Scalia observed that although Maryland's refusal to give residents full tax credits against income taxes paid to other states threatens double taxation and encourages residents to work in Maryland, it also allows the State to collect "equal revenue from taxpayers with equal incomes, avoids the administrative burdens of verifying tax payments to other States, and ensures that every resident pays the State at least some income tax."

Justice Thomas's dissent. Justice Thomas commented that the Court's opinion "proves just how far our negative Commerce Clause jurisprudence has departed from the actual Commerce Clause." The majority of the Court holds that Maryland's failure to give a full credit for taxes paid to other states violates the

Commerce Clause – "[t]hat news would have come as a surprise to those who penned and ratified the Constitution." He said that he doubted that the majority's application of the negative Commerce Clause was correct under the Court's precedents, and was "certain that the majority's result is incorrect under our Constitution."

Justice Ginsberg's dissent. Justice Ginsberg noted that a state may tax *all* of a resident's income – yet under dormant Commerce Clause jurisprudence, "the Court decides, a State is not really empowered to tax a resident's income from whatever source derived." Because more is given to residents of a State than to those who reside elsewhere, more may be demanded of them – and the cost of services that are only available to residents is substantial. Although it was true that some of the Wynnes' income was taxed twice, the Wynnes "enjoyed equal access" to the State's services; now, with the Court's decision, they "will have paid $25,000 less [presumably the amount of the credit against their county tax] to cover the costs of those services than similarly situated neighbors who earned their income entirely within the State."

Justice Ginsberg summed things up this way: "This case is, at bottom, about policy choices: Should States prioritize ensuring that all who live or work within the State shoulder their fair share of the costs of government? Or must States prioritize avoidance of double taxation?" She said she would leave that choice to state legislatures and not the Court, and therefore would reverse the lower court decision.

Comments. *Wynne* is a big deal – and Maryland residents who have previously only received a credit against their Maryland *state* income tax for out-of-state taxes paid for "source" income in those other states are presumably now entitled to a credit against their *county* tax as well (residents who have been following the case closely have been filing protective refund claims to preserve their rights if Maryland lost in the Supreme Court; apparently there are already some 8,000 refund claims totaling $200 million). Going forward, then, Maryland needs to adjust its tax law, and counties will presumably receive fewer tax dollars, which could necessitate some difficult choices.

What does *Wynne* mean for taxpayers in other states? That remains to be seen. The Court viewed Maryland as an "outlier" because it doesn't give a full "state" credit for out-of-state income taxes that Maryland residents pay to other jurisdictions on out-of-state income. In other words, the Court (like the Maryland Court of Appeals) views the state and county taxes as "State" taxes, and not as separate taxes. Thus, even though Maryland gives a full credit against the "state" portion of the State tax and gives no credit against the county tax, the Court still views that as a partial credit, which potentially subjects the out-of-state income to double taxation and thereby violates the dormant Commerce Clause.

Yet does Maryland really have such an "unusual tax scheme"? Without doing an exhaustive study of the 40+ states with income taxes, it is hard to say. But it is interesting to see what the International Municipal Lawyers Association (IMLA) said in its *amicus* (or "friend of the court") brief in *Wynne*, namely: "Many other state and local governments have made similar choices to provide residents partial credits for foreign income taxes paid." And: "Many municipal governments impose taxes on residents' net income without a full credit for taxes paid in other states." As an example, the IMLA brief cites New York State, where two cities – New York City and Yonkers – impose an income tax: "And although a foreign tax credit is provided against the state-level income tax, no credit is provided against this municipal income tax."

So how might *Wynne* play out in New York? Let's look at this example: Sally is a New York City resident, and is therefore subject to both New York State *and* City income tax on all of her taxable income. She inherits her deceased mother's California home and sells it in 2014. Sally pays California income tax on the gains, which are also subject to New York State and City income tax. On her 2014 New York State return, Sally claims a New York *State* credit for some of that California tax, but can't claim a New York City credit for it – meaning that because she doesn't get a full New York credit for the California tax she paid, some of her gain is taxed twice at the state level. Is this structure constitutional in light of *Wynne*…and does it matter that Sally's gain is from out-of-state real property rather than income from an out-of-state business, as with the Wynnes? Assuming that *Wynne* stands for the proposition that double taxation of out-of-state income is unconstitutional, that distinction should not matter. Accordingly, if Sally now files a refund claim for the "missing" New York City credit, will New York State comply, or is Sally looking at what could be very costly litigation? The answer is unknown, although litigation would not be a surprising outcome.

To echo Justice Ginsberg's observation, *Wynne* really is about policy decisions and a state's ability to tax its residents. It is undisputed that residents enjoy benefits, many of which are only available to residents; in *Wynne,* the result is that a resident taxpayer will now get a full credit for out-of-state taxes, and thereby pay less for local benefits than a neighbor with the same amount of taxable – purely in-state – income. Yet taxes always involve competing equities, which can never be fully reconciled. With *Wynne*, the Court held that the overriding equity is to prevent out-of-state income from being taxed twice.

Post-*Wynne*, states and municipalities are bound to be looking carefully at their tax laws to see whether they need to change those laws or anticipate challenges to them. And taxpayers who feel that their particular situation may fall within the *Wynne* parameters might want to consider making a protective refund claim so that the statute of limitations does not run out on that claim – in anticipation of their home state providing clarity on the issue. *Wynne* raises many questions that have yet to be answered. Stay tuned.

p.s. What about "statutory residency" and portfolio income? Suppose two states claim someone as a resident and tax *all* of the taxpayer's income, with no credit to the other state for taxes paid on, say, portfolio income, such as dividends and capital gains. Does *Wynne* now preclude this result? Let's look at this example:

John has a substantial brokerage account that generates significant income for him. He lives in New Jersey but works in New York City, where he maintains an apartment. Because John is in New York City for more than 183 days *and* maintains a permanent place of abode there, he is what's known as a "statutory resident" – of both New York State and City. As such, he is subject to New York State and City income tax on *all* of his income, and not just on what he earns there (his "source income"). New Jersey gives him a credit for the New York tax he pays on his source income, but not for the New York tax on his portfolio income; New York will not give him a credit for the New Jersey tax on any of his income. Result: John is taxed twice on his portfolio income.

Doesn't this double taxation run afoul of the Commerce Clause and burden interstate commerce? John Tamagni, whose facts are outlined above, certainly thought so. He argued his case all the way to New York's highest court, the Court of Appeals, and lost nearly 20 years ago (the Supreme Court declined to hear his case). Would John still lose today? Arguably yes. The Court of Appeals said that the New York tax to which John was subjected on all of his income had nothing to do with his daily commute and economic activities in New York, but was strictly a function of the statutory residency rules: i.e., his presence in New York, coupled with his maintaining a permanent place of abode in New York. "Indeed, the fact that commuters who do not own or lease property in New York are not subject to this tax demonstrates that the tax is completely indifferent" to interstate activities, and therefore does not implicate the Commerce Clause. *Tamagni v. Tax Appeals Tribunal of the State of New York*, 91 N.Y.2d 530 (1998).

Statutory residency can thus catch "intangible property," such as stocks and bonds, and the income such property generates. In other words, intangible property is deemed to "reside" with its owner and is not considered to have a state "situs" (unlike, say, real estate and tangible personal property) *unless* it has to do with a trade or business conducted in that state. Accordingly, income from intangible property is typically taxable in the state in which its owner resides; if two states claim that owner as a resident – namely, the domiciliary state and the state where the owner tripped the statutory residency rules – both states can tax that income, with no offsetting credits for what the other state charges. So yes, double taxation can happen.

Does *Wynne* give taxpayers caught in this unfortunate situation new hope? Never say never, but the statutory residency rules, which simply look to a taxpayer's "presence" in a jurisdiction, seem different from the issue in *Wynne*: namely, whether the dormant Commerce Clause precludes the double-taxation of out-of-state income.

June 7520 rate

The IRS has issued the June 2015 applicable federal rates: the June 7520 rate is 2.0%, a 0.20% (20 basis points) increase from May's 1.8% 7520 rate. The June mid-term rates are: 1.60% (annual), 1.59% (semiannual and quarterly) and 1.58% (monthly). The May mid-term rates were: 1.53% (annual) and 1.52% (semiannual, quarterly and monthly).

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