



## The Future of Interstate Commerce Taxation: The United States Supreme Court and the Wynne Case

On November 12th, the U.S. Supreme Court will hear oral argument in the closely-watched case of *Maryland Comptroller of the Treasury v. Wynne*, in which the Court's decision potentially could have a significant impact on multistate income taxation of individuals, including flow-through business entity owners, and perhaps even C-corporations. SC&H's own Karen Syrylo initiated the Constitutional argument when Mr. Wynne's appeal of his Maryland tax assessment was in the Maryland Tax Court. In this article Karen summarizes the arguments that have been made on both sides of the controversy, and traces the history of the dispute through the Maryland courts. The article also discusses the estimated fiscal impact to the state and the legislature's reaction to the refund claims filed by taxpayers in light of the Maryland Court of Appeals' holding in favor of Mr. Wynne. Finally, Ms. Syrylo comments on possible effects and remaining unanswered questions depending on how the Supreme Court rules.

To the surprise of many, the United States Supreme Court has agreed to hear the state's appeal in *Maryland Comptroller of the Treasury v. Wynne*, 431 Md. 147 (2013), cert. granted, 82 U.S.L.W. 3685 (U.S. May 27, 2014) (No. 13-485) in its 2014-2015 session. It was surprising because the Court takes extremely few state tax cases, and because the issue at stake exists chiefly—or perhaps only—in Maryland, based on current provisions of other states' tax laws.

Regardless of which way the Court rules, the decision will have important results not only for Maryland taxpayers, but perhaps also for individuals across the nation who conduct interstate business. And some question whether the Court's ruling may also impact the multistate taxation of corporations.

The case is centered on the ruling by Maryland's Court of Appeals, the state's highest court, which found that Maryland's lack of credit against the "local" portion of the individual income tax, for taxes paid to other states on income generated in and taxed by those other states, violates the Commerce Clause of the U.S. Constitution. The court concluded that the resulting Maryland tax is not fairly apportioned and discriminates against interstate commerce. Essentially, the court reasoned that the taxation by Maryland of non-Maryland interstate commerce income was an incentive for Maryland residents to conduct business only in Maryland and thus impeded multistate commerce.

The Maryland Comptroller's cert petition asks that the Supreme Court address the question: "Does the United States Constitution prohibit a state from taxing all the income of its residents - wherever earned - by mandating a credit for taxes paid on income earned in other states?"

I say it this way: Does the Commerce Clause of the U.S. Constitution apply to interstate commerce income of an individual as it does to the income of corporations, thus putting limitations on how a state may tax that income? Or does the state of the individual's residence have an overriding power to tax 100% of the resident's income - even interstate commerce income that is also taxed in the source state?

## The Tax at Issue

Maryland's individual income tax rate is composed of two parts: the "state" rate, currently graduated from 4.75% to 5.75%, and the "local" rate, otherwise known as the "piggyback," currently ranging from 1.25% to 3.2% depending on the locality. The Maryland Court of Special Appeals has previously agreed with the Comptroller's prior assertion that "the county tax imposed on residents is a state tax for constitutional purposes" in a case involving the "special nonresident tax" imposed on nonresidents. See *Frey v. Comptroller*, 184 Md. App. 315 (2009).

For residents who earn both Maryland-based and non-Maryland-based income, the Maryland tax is calculated in several steps:

1. the "state" tax rate is applied to the individual's total Maryland taxable income based on 100% of federal taxable income;
2. the "local" tax rate for the county of the individual's residence, is applied to the individual's total Maryland taxable income based on 100% of federal taxable income;
3. credit for taxes paid to other states on income earned in such other states is calculated at the lesser of: (a) the tax actually paid to the other state, or (b) Maryland's "state" (e.g. 4.75%) rate on the non-Maryland income;
4. the net of line 1 plus line 2 minus line 3 equals the total tax owed to Maryland.

Thus, the limitation of the credit to Maryland's "state" rate means that non-Maryland income is left in the calculation against the "local" rate (line 3). Maryland is taxing, at the "local" rate, the non-Maryland income on which the individual has been taxed by the other states.

It is important to note that Maryland also imposes tax on nonresidents who earn Maryland sourced income, *i.e.* the portion of the individual's federal taxable income that is deemed attributable to Maryland:

1. the "state" tax rate is applied to the individual's total Maryland taxable income;
2. the "special nonresident tax" rate, specifically set by statute to always equal the lowest "local" tax rate applied to residents, is applied to the individual's Maryland taxable income;
3. the total of line 1 plus line 2 equals the Maryland tax.

## Summary of the Taxpayer's Argument

First and importantly, the case involves interstate commerce income of an individual, Mr. Wynne, earned by him via the multistate business operations of the S corporation in which he was a shareholder. Maryland follows the federal provision that makes the S corporation's income the shareholders' income on a pass-through basis, with the same character in the hands of the shareholders as it has when earned by the S corporation. Although the Comptroller initially made arguments that the income was passive (dividends) and therefore interstate commerce was not at issue, the appellate courts rejected that position and applied the Commerce Clause analysis.

The taxpayer claims that Maryland's tax provision is unconstitutional under several principles outlined by the U.S. Supreme Court in its cases dealing with the limitations placed by the Commerce Clause on state taxation of interstate commerce, the so called "dormant Commerce Clause," as follows:

\* The taxation of non-Maryland income at the "local" tax rate, *i.e.* without credit against the "local" tax rate, has the same effect as not fairly apportioning the multistate income. That a tax must be fairly apportioned is one of the four tests required by the Court in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

\*Maryland's tax structure is not "internally consistent." The Court discussed this aspect of an acceptable tax in its ruling in *Container v. California Franchise Tax Board*, 463 U.S. 159 (1983). To pass constitutional muster, a tax must be internally consistent, meaning that if, hypothetically, every state employed the same taxing formula, it would result in no more than all of the business income being taxed. In other words, there can be no built in risk of multiple taxation. Clearly, under Maryland's statute there is multiple taxation - the non-Maryland income is taxed both by Maryland on the resident return and by the source state on a nonresident return. And worse, if every state in the union employed Maryland's formula, there would *always* be multiple taxation of the same dollar of income: both by the residence state and by the source state.

\* Maryland's tax structure also is not "externally consistent." This concept involves the question of whether the state's tax is imposed only on that portion of the income that is fairly attributable to economic activity in the taxing state. See *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995). In that decision the court also said that the threat of multiple taxation may indicate a state's impermissible overreaching. In the *Wynne* case, there is actual multiple taxation and not just a "threat," and so the Maryland statute also fails this test and is unconstitutional.

\* Yes, the starting point is the principle that a state can tax all of its residents' income, but after that starting point the Commerce Clause principles outlined above place limitations on the states to the extent that the income is interstate commerce income.

### Summary of the State's Argument

Throughout the several court levels including into its cert petition, the Comptroller has contended that a state has the right to tax 100% of its residents' incomes, even interstate commerce income earned outside the state. The case most cited by the Comptroller is *Oklahoma Tax Comm'n v. Chickasaw Nation*, 515 U.S. 450, (1995). The case involved U.S. law and treaties regarding Native American tribes. The lower court had held that Oklahoma could not tax the wages of tribal members employed by the Tribe even if they resided outside Native American country. But the U.S. Supreme Court reversed, saying in its decision: "Oklahoma may tax the income (including wages from tribal employment) of all persons, Indian and non-Indian alike, residing in the State outside Indian country. The Treaty between the United States and the Tribe, which guarantees the Tribe and its members that 'no Territory or State shall ever have a right to pass laws for the government of' the Chickasaw Nation, does not displace *the rule, accepted interstate and internationally, that a sovereign may tax the entire income of its residents.*" (emphasis added)

I note that the Chickasaw decision did not include a discussion of the Commerce Clause.

The state's briefs in *Wynne* include references to the different relationship between a resident and the state compared to a nonresident and the state. There is long discussion about Maryland's budget dollars and the government's services that residents but not nonresidents can claim, such as K-12 education. The state argues that giving the full credit, i.e. against both the "state" and "local" portions of the tax, results in the resident not paying his fair share of the government's costs for services that are available to him.

The state goes further with the position that multiple taxation is not unconstitutional, because the residence state has the right to tax all of the resident's income in order to pay for the state's services, and that the state can tax an apportioned share of a nonresident's income, i.e. the portion that is generated in Maryland. The state's explanation of why multiple taxation is acceptable is that the two tax schemes have different foundations - the resident tax is based on the privilege of residing in the state, and the nonresident tax is based on the privilege of earning income in the state.

## The Proceedings

The case has had an interesting procedural history.

The Maryland Tax Court ruled for the Comptroller in a short oral opinion (unwritten/unreported). The judge simply said that he saw no constitutional argument, and briefly mentioned the Maryland Court of Appeals' decision in *Comptroller v. Blanton*, 390 Md. 528 (2006). That ruling held that the state's statute was clear that the credit applied only to the "state" portion of the tax.

On appeal by the taxpayer, the Howard County Circuit Court issued a detailed 80-page opinion that discussed the precedents cited by the taxpayer in his argument as well as additional authorities. The Circuit Court agreed with the taxpayer that Maryland's partial credit mechanism violated the Commerce Clause of the U.S. Constitution. The court noted that the *Blanton* case mentioned by the Tax Court judge was decided based on statutory language only and did not address the constitutional question. The court went on to outline that the S corporation's income, and therefore the individual's income, was from interstate commerce, and did an exhaustive analysis of the Commerce Clause including the requirements set forth in *Complete Auto Transit*.

The Court of Appeals agreed to hear the Comptroller's appeal directly (the case skipped the Court of Special Appeals level). On January 28, 2013 the Court of Appeals issued its 5 to 2 decision in favor of the taxpayer. The court said "We find merit in the taxpayer's contentions and affirm the judgment of the Circuit Court." That statement was followed by a 30-page decision in which the court went into the details of its dormant Commerce Clause analysis, including a numerical example showing the double taxation, and a rebuff to the Comptroller's arguments. Interestingly, the majority opinion also discussed in a rather long footnote the majority's analysis of the two dissenting judges' dissenting opinion, and said "we find its legal analysis unpersuasive."

On February 27, 2013, the Comptroller filed its motion for the Court of Appeals to reconsider and reverse its January ruling, saying that the "apparent premise" of the court's reasoning was incorrect, and restating its positions from the briefs and oral arguments. The motion also requested that, in the alternative to a reversal, the court declare

that its ruling would operate only prospectively for all taxpayers other than the Wynnes, and that the court stay enforcement of the judgment pending further appeal or legislative action. On May 17 the court issued its order denying the motion for reconsideration but granting the stay pending the disposition of the state's appeal to the U.S. Supreme Court. The court also responded to a statement in the Comptroller's motion by saying "A state may avoid discrimination against interstate commerce by providing a tax credit, or some other method of apportionment," thus resolving the state's interpretation that only a credit mechanism is what is mandated for constitutionality. The order did not deal with the Comptroller's other request regarding prospective-only treatment.

After the Comptroller filed its petition for certiorari with the Supreme Court and the taxpayer filed its reply brief, the Court on January 13, rather than announcing a grant or denial of cert, issued an order instructing the U.S. Solicitor General to express "the views of the United States" regarding Maryland's petition for cert. This step is unusual although not rare; it usually involves questions of a case's impact on the federal government, and so was puzzling to some because the *Wynne* case involves state taxation and not federal law.

In another surprise to some, the Solicitor General's brief to the Supreme Court in April stated that "The decision below is incorrect and warrants this Court's review." The brief includes discussion that largely reflects similar arguments and authorities as in the state's briefs, and also discussion of Due Process principles and a rejection of the notion that the Commerce Clause analysis should apply to a state's taxation of its individual residents. The Solicitor General concluded "In light of the immediate impact of the decision below on the sovereign interests and fiscal solvency of Maryland, there is no sound reason to delay review. The petition for writ of certiorari should be granted."

On May 27, 2014 the Supreme Court issued its order granting cert.

### **Estimated Fiscal Impact of the Case**

On January 16, in the beginning weeks of the 2014 legislative session, the Maryland House Ways & Means Committee received a briefing about the potential fiscal impact of the *Wynne* case should the taxpayer prevail. The Committee was told by the Comptroller's Office that their current estimate for refunds of tax plus interest at the current statutory rate of 13% was \$241 million (\$190 million of tax and \$51 million of interest), and that for future tax years the income tax revenues would decrease by \$42 million annually due to the increased credit amount. A chart contained in the Comptroller's materials showed that the largest impacts were to Montgomery, Baltimore, Anne Arundel and Howard counties, with Montgomery County bearing over 50% of the total impact. The videotape of the briefing is available on the General Assembly's website, and makes for some entertaining viewing at the point when one of the Delegates opines "We're gonna lose, sooner or later. I can't believe [the Supreme Court] didn't kill us last week" (i.e. with cert denial). The video can be found at <http://mgahouse.maryland.gov> and the comments mentioned are located at approximately minute 46.

### **Interest Rate Reduction Snuck into Legislation at the End of the Legislative Session**

Maryland's statutory rate of interest payable on tax refunds where the taxpayer is not at fault is 13%, right?

Wrong, at least wrong for the “Wynne” refund claims. I hazard a guess that no one was predicting the action the legislature would take this session, even though we knew how concerned the legislators and county administrators have been about the impact on state and local funds should Mr. Wynne win at the Supreme Court.

On pages 43 and 44 of Senate Bill 172, the Budget Reconciliation and Financing Act of 2014 (the companion bill in the state budget balancing process - it can raise taxes, shift revenues, change spending mandates, etc.), in Sections 16 and 20 of the “enactment clauses” (i.e. not a change to the codified statutory language), a change was made in the final days of deliberation by the legislative committee charged with agreeing on the state’s budget provisions. Section 16 of the Senate Bill provides that “notwithstanding any other provision of law” (i.e. the current 13%), “the annual interest rate for an income tax refund that is a result of the final decision under *Maryland State Comptroller of the Treasury v. Brian Wynne*” is the “average prime rate of interest quoted by commercial banks to large businesses.” In other words, this provision prescribes a special rate that is currently about 3%.

And the provision applies retroactively to claims already on file, because Section 20 provides that Section 16 “applies only to income tax refunds attributable to taxable years beginning after December 31, 2005 but before January 1, 2015.” (The tax year 2006 was likely chosen as the starting point because that’s the year of the assessment to Mr. Wynne that began this litigation saga.)

Thus, in the late days of the legislative session, without being discussed in a public hearing with opportunity for public comment or even public knowledge, Maryland’s interest rate for “Wynne” refunds was changed from 13% to roughly 3%.

Additionally, although the provision is retroactive, and applies to a select group of taxpayers rather than to all, the Attorney General’s May 14, 2014 report to the Governor opines: “We believe that the provision is constitutional and legally sufficient. The Court of Appeals has stated that ‘interest on a tax refund is a matter of grace which can only be authorized by legislative enactment.’” (citing *Comptroller v. Fairchild Industries, Inc.*, 303 Md. 289, 284 (1985)) (The report is available at <http://mgaleg.maryland.gov>)

### Where Are We Today?

Literally thousands of refund claims have been filed for prior years, for amounts small and large. Maryland is a small-business state and has many small businesses, as well as a few larger ones, that are organized as pass-through entities. All of the Maryland-resident owners of these businesses are impacted by the *Wynne* issue. In addition to amended returns for prior years’ refund claims, some taxpayers are filing their current returns with calculation of the credit against both the state and local tax rates. The Comptroller is simply storing the refund claims.

And for original returns that are filed using the “Wynne” calculation, the Comptroller’s Office is sending adjustment notices and bills to the taxpayers for the excess over the current statutory credit amount. These notices need to be appealed timely by the taxpayer; the Comptroller will hold the appeal pending the decision of the Supreme Court.

Briefs of the parties and amicus briefs for both sides have been filed. Oral argument is scheduled for November 12, and final decision is likely in the spring, by June 2015.

## Where Might Wynne Lead?

If the U.S. Supreme Court affirms the Maryland Court of Appeals' decision, the Comptroller's Office will need to process the refund claims. The state or counties will need to issue refund checks. Key questions include: Will it be the counties or the state or some combination whose funds will be used for the refunds? And will there be a taxpayer challenge to the legislated change in the interest amount? The legislature will need to adjust the current credit provision to comply with the Constitutional restrictions; what will that change be? And the state and counties will need to address current and future budgets to manage the impact of the refund payments and future results of the needed law change - will there be expenditure reductions? Revenue (tax) increases?

If the U.S. Supreme Court overturns the Maryland Court of Appeals decision and holds for the state, what will Maryland do? What will other states do? The likely answers largely depend on exactly what the Court says in its decision. But will Maryland keep its current partial credit and current denial of local credit? Or will the state choose to reduce its credit even further? Will other states change their current provisions to reduce the credit they grant for taxes paid to other states? In short, could we be looking at double taxation of most interstate commerce conducted by individuals and pass-through entities across the country, if both the source states and the residence states are allowed to tax the interstate commerce income? And could a state win on this resident income tax issue bleed into changes in how dormant Commerce Clause restrictions are applied to the taxation of multistate corporations' income?

Stay tuned!

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