AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

UNITED STATES SUPREME COURT HOLDS MARYLAND DISALLOWANCE OF RESIDENT CREDIT AGAINST COUNTY INCOME TAX UNCONSTITUTIONAL

SUMMARY

On May 18, 2015, the United States Supreme Court issued its decision in *Comptroller of the Treasury of Maryland v. Wynne*, No. 13-485, 575 U.S. ___ (2015), in which the Court held that Maryland's limitation on the use of a resident credit for taxes paid to other states as an offset against the state portion of the personal income tax only, and not the county portion of the tax, violates the Commerce Clause of the United States Constitution. The Court's decision opens the door to a tidal wave of refund claims for those taxpayers that were denied the credit or overlooked taking the credit against the county tax for taxes paid to other states on returns filed with the state, as well as for those taxpayers who have protective refund claims pending with the Comptroller.

DETAILS

Background

Maryland imposes a tax on the income of a resident individual earned within and without the state, and the income of a nonresident earned from sources within the state. The Maryland income tax is composed of a state tax on residents and nonresidents, a county tax imposed only on residents at rates that vary by county, and a special nonresident tax imposed at the lowest county rate. Maryland allows a resident taxpayer a credit for taxes paid to another state, but has statutorily limited the use of the credit as an offset against only the state portion of the tax.

The taxpayers in *Wynne*, Brian and Karen Wynne, were residents of Howard County, Maryland, who had income from sources outside the state via an ownership interest in an S corporation doing business throughout the United States. They used taxes paid to other states as an offset against the state and county taxes reported on their 2006 Maryland income tax return. The Maryland State Comptroller denied the taxpayers' use of the resident credit as an offset against the county tax and assessed tax accordingly. The taxpayers appealed the assessment, which was upheld at the administrative level and by the

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Maryland Tax Court. The Circuit Court for Howard County, Maryland, reversed the decision of the Tax Court and the Maryland Court of Appeals affirmed the Circuit Court's decision. The Comptroller then petitioned the United States Supreme Court for a writ of certiorari, which the Court granted.

Majority's Holding and Reasoning

The Court's 5-4 majority affirmed the decision of the Maryland Court of Appeals and held that Maryland's limitation on the use of the resident credit violates the "dormant" Commerce Clause of the United States Constitution.[1] The Court reasoned that Maryland's tax scheme inherently discriminates against interstate commerce because it fails the internal consistency test – a judicially developed doctrine which asks whether the hypothetical adoption of a tax scheme by all states would result in multiple taxation of interstate commerce. In this case, the Court's majority found that if every state adopted a tax scheme similar to Maryland's (*i.e.*, a 1.25% tax on the income of a resident earned in the state, a 1.25% tax on the income of a resident earned outside the state, and a 1.25% tax on the income of a nonresident earned in the state), then income earned by a taxpayer outside its state of residency would be subject to a 1.25% tax twice, whereas, the income earned by a taxpayer inside its state of residency would be subject to a 1.25% tax once. Thus, the Maryland tax scheme subjects the income earned by residents to double taxation and impermissibly discriminates against interstate commerce in favor of intrastate commerce.

In so holding, the majority rejected the argument that dictum in *Goldberg v. Sweet*, 488 U.S. 252 (1989) dictates that the "dormant" Commerce Clause does not protect state residents from their own tax because residents unhappy with a tax scheme may change the tax through the state's political process. Therefore, according to the majority, while the Due Process Clause of the Fourteenth Amendment may allow a state to favor intrastate activity, the Commerce Clause may act as a restraint on that authority. The majority also rejected any argument that the "dormant" Commerce Clause is a "judicial fraud" or does not otherwise exist, that the Commerce Clause distinguishes between taxes on net and gross income, or that the Commerce Clause could treat individuals less favorably than corporations. Thus, the internal consistency test – a test that looks solely to the economic impact of the tax – appears to be alive and well and to apply to income and gross receipts taxes, taxes that favor residents and nonresidents, and taxes on corporations and individuals alike.

BDO INSIGHTS

- Maryland resident taxpayers who believe they may be entitled to a refund claim as a result of the decision in *Wynne*, should consult with their tax advisors regarding refund claims, which would presumably be limited under Maryland's three-year statute of limitations on tax refunds. Affected taxpayers who followed the development of this issue through the courts will likely have filed protective claims for refund before the period of limitations expired for a particular taxable year. Such claims should now be processed in due course by the Comptroller. While a state may usually cure a constitutional violation by either "leveling up" those that are subject to less tax under the unconstitutional tax or "leveling down" those that are subject to more tax under the unconstitutional tax, it appears that Maryland is in a position where it must "level down" and allow the resident credit as an offset against the county tax. This is because if Maryland were to disallow the resident credit in its entirety, and assuming the hypothetical adoption of such a tax scheme by all states, the taxpayers in *Wynne* (and other similarly situated taxpayers) would still be subject to double tax on income earned in interstate commerce, whereas resident taxpayers with no income earned outside the state would still only be subject to one level of tax.

- The Court's decision in *Wynne* leaves Maryland liable for at least $202 million in tax refunds with Montgomery County expecting to bear a large portion of this burden – *i.e.*, an estimated $8 to $10 million in fiscal year 2016 and $50 million in fiscal year 2017.[2] It is unclear whether these estimates take into account revenue shortfalls that will likely result from allowing the full resident credit on future returns. It will be interesting to see what actions Maryland and its localities will take to cover any budget shortfalls as a result of the decision in *Wynne* – *i.e.*, reduce expenditures or increase taxes. Perhaps the amnesty program Governor Larry Hogan (R) approved in April 2015, which requires the

[1] Justice Alito delivered the opinion of the Court, in which Chief Justice Roberts, and Justices Kennedy, Breyer, and Sotomayor joined. Justice Scalia filed a dissenting opinion in which Justice Thomas joined in part, Justice Thomas filed a dissenting opinion in which Justice Scalia joined in part, and Justice Ginsburg filed a dissenting opinion in which Justices Scalia and Kagan joined.

[2] Jennifer De Paul, "Maryland Counties Owe Millions in Tax Refunds Under *Wynne* Decision," *State Tax Today* (May 19, 2015).

Comptroller to declare a tax amnesty period that runs from September 1, 2015, through October 30, 2015, and which is anticipated to increase revenue by $11.4 million in fiscal year 2016 and $3.6 million in fiscal year 2017, was intended to recoup some of the losses as a result of the anticipated decision in *Wynne*.[3] *See* State and Local Tax Alert - April 2015, "Maryland Introduced a New Two-Month Tax Amnesty Program in 2015."

- Maryland may not be the only state affected by the decision in *Wynne*. For example, as was noted in Brief for the International Municipal Lawyers Association and Other State and Local Government Groups as Amici Curiae in Support of Petitioner, "Wisconsin and North Carolina provide credits for state-level foreign income taxes but disallow credits for city, county and local foreign income taxes." In addition, "…in New York State, two cities (New York City and Yonkers) impose an income tax . . . [, a]nd although a foreign tax credit is provided against the state-level income tax, no credit is provided against the municipal tax." Thus, similar to Maryland, there may be an opportunity for a refund claim in these and other states.

- In anticipation of the decision in *Wynne*, the Maryland legislature recently passed legislation that would, if approved by Governor Hogan, effective for taxable years beginning after December 31, 2014, allow a resident credit as an offset against the county tax in the event of a United States Supreme Court decision affirming the Maryland Court of Appeals.[4] Thus, for taxable years beginning after December 31, 2014, Maryland residents should be able to take the resident credit as an offset against the county tax without risk that the state would disallow it.

- Also in anticipation of the decision in *Wynne*, in 2014, Maryland passed a law that would retroactively reduce the interest rate on refunds issued as a result of the decision in *Wynne* from 13% (a rate that ordinarily applies to assessments of tax as well as refunds) to "a percentage, rounded to the nearest whole number, that is the percent that equals the average prime rate of interest quoted by commercial banks to large businesses during fiscal year 2015."[5] Thus, taxpayers that seek a refund of tax as a result of the decision in *Wynne* will be ineligible to receive interest on refunds at Maryland's very favorable 13% interest rate. In a letter to then Maryland Governor Martin O'Malley (D) dated May 14, 2014, then Maryland Attorney General Douglas F. Gansler (D) stated his position that the limited application of the reduced interest rate is constitutional and legally sufficient because the Maryland Court of Appeals has stated on numerous occasions that entitlement to interest on a tax refund is a matter of grace which can only be authorized by legislative enactment and, thus, "determining the interest rate is a perfectly acceptable exercise of legislative power." Nevertheless, legal challenges to these interest-rate provisions could also arise when refunds based on the *Wynne* decision are processed.

[3] *See* S.B. 763, Reg. Sess., Fiscal and Policy Note (rev.) (Md. 2015).

[4] *See* H.B. 72, Reg. Sess., §§ 4 and 26 (Md. 2015).

[5] *See* S.B. 172, Reg. Sess., § 16 (Md. 2014) (enacted).