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FEATURED PERSPECTIVE

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This article provides a brief overview of the *Wynne* proceedings and notes that the case has attracted national media coverage in Canada and is being closely watched by Canadian tax practitioners because of the similarities in the two countries' form of government.

On November 12, 2014, the U.S. Supreme Court heard oral arguments in *Comptroller of the Treasury v. Wynne*, 431 Md. 174 (2013) — an income tax case that Supreme Court watchers have described as too close to call[1] and that could have profound implications not only in the United States but also in Canada.[2]

I. Overview and Procedural History

Wynne involved a component of Maryland's state income tax (the county income tax) imposed on the entire income of Maryland residents with no credit for out-of-state income taxes paid. Consequently, when a Maryland resident earns income in another state subject to that state's income tax, that income faces double taxation. The Wynnes found themselves in such a situation because of significant earnings received through an investment in an S corporation operating in about 40 different states.

In a 5-2 decision, the Maryland Court of Appeals held that the county income tax violated the commerce clause of the U.S. Constitution (Article I, section 8, cl. 3). The commerce clause, as drafted, grants the federal government power to regulate interstate commerce and has been interpreted (under the ''dormant commerce clause'' principle) as also barring states from enacting legislation ''to discriminate against or burden the interstate flow of articles of commerce.''[3] The Maryland Court of Appeals majority reasoned, among other things, that Maryland's tax regime created a disincentive for its residents to pursue income in other states and that if every state had a regime like Maryland's, significant barriers to interstate commerce would result.[4]

The minority of the court dissented, finding it inappropriate that residents should be able to avoid paying for locally provided services simply by earning their income in another state and holding that because the county income tax was not ''facially discriminatory'' (that is, it did

[1]*See, e.g.*, Bradley Joondeph, ''Argument analysis: The fate of Maryland's personal income tax remains unclear,'' SCOTUSblog (Nov. 13, 2014), *available at* http://www.scotusblog.com/2014/11/221484/.

[2]The Maryland Court of Appeals decision, the various briefs filed with the U.S. Supreme Court, and a transcript of oral arguments are available online at http://www.scotusblog.com/case-files/cases/comptroller-v-wynne/. Also, the Maryland Court of Appeals judgment denying reconsideration is available at http://www.mdcourts.gov/opinions/coa/2013/107a11mr.pdf.

[3]*Oregon Waste Systems Inc. v. Department of Environmental Quality,* 511 U.S. 93 (1994).

[4]Rather than striking down the income tax altogether (which, as one might imagine, was the remedy sought by the taxpayers), the Maryland Court of Appeals remanded the case for a recalculation with a credit for out-of-state taxes paid. The court was able to fashion this remedy since the county income tax had previously allowed a credit for out-of-state taxes, and thus the court simply invalidated the amendment that abolished the tax credit. One is left to speculate on the remedy the Maryland Court of Appeals would have ordered had the county income tax been instituted *ab initio* without a tax credit for out-of-state taxes paid.

not expressly discriminate against out-of-state income), the onus lay on the taxpayers to prove that the county income tax unjustifiably burdened out-of-state commerce through its operation. The minority concluded that the taxpayers did not meet this burden of proof.

On reconsideration, the Maryland Court of Appeals upheld its ruling, but clarified that the state of Maryland could potentially remedy the constitutional deficiency of its income tax regime through means other than allowing a tax credit for out-of-state taxes paid.

Maryland applied for certiorari to the U.S. Supreme Court, the processing of which was delayed partly because the Court invited the solicitor general to file a brief in the case. After the United States intervened in support of the application on the side of Maryland, the U.S. Supreme Court granted certiorari on May 27, 2014. In addition to the United States, 21 other parties appeared as amici curiae, including eight on behalf of Maryland (mostly various state and local intergovernmental organizations from across the United States) and 13 on behalf of the taxpayers (mostly business-related organizations such as the National Federation of Independent Business, but also the American Legislative Exchange Council and a pair of law professors).

II. Oral Arguments

The U.S. Supreme Court heard oral argument from Maryland, the United States, and the taxpayers. Maryland focused primarily on the relationship between a state and its residents, and the power of the state's residents to determine by themselves, through democratic processes, what taxes they will bear to pay for the various state services they receive. Maryland argued that if the taxpayers objected to the county income tax, they should pursue a remedy at the ballot box, not before the courts.

Maryland received a particularly strong grilling from Justice Stephen Breyer, who invoked the hypothetical example of a California resident operating a hot dog stand in Hawaii:

> To be specific, you live in California. You have a hot dog stand in Hawaii. All right? It has a $1,000 income. It comes back to California. You pay 13½ California tax. Hawaii wants to charge another 12. So you're paying 25 percent. Can California say: That's fine; we give them no credit for the 11 percent they're paying in Hawaii? So the bottom check that you get is $750, not a 1,000. But if your hot dog stand were in California, the check would not be 750, it would be approximately 900. Okay? Now, is that constitutional or not?[5]

In their interventions, Chief Justice John Roberts and Justices Anthony Kennedy, Samuel Alito, and Sonia Sotomayor also evidenced varying degrees of skepticism about whether, constitutionally, California can effectively subject the income from the hot dog stand in Hawaii to nearly double the tax that would apply were the stand located in California. On the other hand, Justice Antonin Scalia seemed to support the right of California to impose its ordinary income tax upon the hot dog stand, questioning, ''why it is that California has to yield in this California-Hawaii situation?''[6]

The United States argued that state income tax imposed on residents and that imposed on nonresidents for transactions within the state have different jurisdictional rationales that make the double taxation of out-of-state income constitutionally permissible. The U.S. offered the hypothetical scenario of a company that has all its manufacturing in one state and all its sales in another:

> If an operation manufactures all of its widgets in State A and sells them all in State B, it's clear under this Court's decisions in *McGoldrick v. Berwind-White Coal Mining Company* and *Armco v. Hardesty* that State A can impose a manufacturing tax that is measured by the value of the revenue of the sales even though the sales occur in State B. And State B can impose a gross receipts tax on the sales that occur in State B which is paid by the seller, the mining company or the widget manufacturer in my example, which is also taxed on that same value, the taxes that occur in State B. The reason that's permissible is because they're distinct jurisdictional rationales, which is what we have here. One is a tax based on the residency and the other is tax based on doing business in the State.[7]

Sotomayor challenged the United States with the observation, ''You say it's a [tax] on residency, but not income. But we have previously said a tax on sleeping, measured by the number of shoes you have in your closet, is a tax on shoes.''[8] Breyer and Kennedy also pursued the point that corporate income tax is constitutionally required to be apportioned in a ''fair'' manner among the states.

The United States replied that if any income tax should be found unconstitutional under the dormant commerce clause, it should be the tax imposed by a state on nonresidents, which is not only the proximate source of any disruption of interstate commerce but also a tax imposed on parties with no power to challenge it at the ballot box. Alito and Breyer both dismissed this argument as nonresponsive, the latter quipping, ''Switzerland has a tax on milk from cows that

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[5]Transcript of Oral Argument, at 6, *Maryland Comptroller of the Treasury v. Wynne*, Sup. Ct. Dkt. No. 13-485, *available at* http://www.supremecourt.gov/oral_arguments/argument_transcripts/13-485_114p.pdf.

[6]*Id.* at 9.

[7]*Id.* at 25.

[8]*Id.* at 19.

are pastured at less than 5,000 feet. It's Belgium's fault. They don't have any mountains.''[9]

The taxpayers' oral arguments focused on the fact that Maryland's failure to provide a tax credit for out-of-state taxes amounted to the imposition of a tariff and was thus prima facie unconstitutional under the dormant commerce clause. While accepting the principle that a state is constitutionally entitled to tax its residents on their worldwide income, the taxpayers argued that a state must structure its tax regime to avoid a ''substantial nationwide risk of double taxation'' with other states. The taxpayers essentially urged the Court to apply its jurisprudence on corporate income taxes — which must be apportioned ''fairly'' among various states — to individual resident income tax.

The taxpayers were challenged on a variety of fronts by the Court. Breyer asked whether out-of-state income taxes can be considered an ordinary cost of doing business in another state. Justices Ruth Bader Ginsburg, Elena Kagan, Kennedy, and Scalia focused on a scenario in which a state resident with all of his income earned out of state may benefit from state services while paying no state income taxes at all:

> [S]uppose we had a Maryland resident and all that resident's income is earned out of State. And each of the States where the income is earned tax at or above the Maryland rate. That would mean, I suppose, that the Maryland resident owes nothing to Maryland because he could take a credit for all what he's — leaving the residents without anything, without a penny from this resident who may have five children that he sends to school in Maryland.[10]

A discussion ensued on the panel on how states might seek to make up ''lost'' revenue caused by the income of its residents being taxed by other states — including increased property taxes, increased income taxes, a school support tax, or a flat tax — as well as whether such measures would disproportionately affect lower-income people. Scalia expressed particular consternation at the suggestion that the state could fill any revenue gap without affecting lower-income residents by raising the state's top marginal tax rate.

Kagan and Ginsburg also questioned why residence-based income taxes should be the ones to yield to source-based income taxes, particularly given the diversity among the states in their taxation systems. They also raised — largely in response to the taxpayers' assertion that Maryland was unique in not providing a credit for out-of-state income taxes paid — the issue that many local income taxes across the United States do not provide a tax credit for other income taxes paid.

III. U.S. and Canadian Implications

Whatever decision the U.S. Supreme Court reaches is expected to have a wide-ranging impact on state and local taxation across the United States. A victory by the taxpayers will no doubt prompt a host of new challenges to other state and local tax regimes on double taxation grounds and potentially usher in a new era of judicial review of tax legislation. On the other hand, a victory by Maryland may inspire state legislatures to scale back their tax credit regimes, making at least some double taxation of out-of-state income the norm rather than the exception.

The government of Maryland has already received, apparently, thousands of refund requests in the wake of the Maryland Court of Appeals decision. The Maryland Comptroller's Office estimated the expected refund requests following *Wynne* at more than $240 million, in response to which Maryland hurriedly enacted legislation in early 2014 retroactively cutting the interest rate payable by the state on ''an income tax refund that is a result of the final decision under *[Commissioner] v. Wynne*'' from 13 percent to around 3 percent (the Budget Reconciliation and Financing Act of 2014, SB 172). Whether this legislation passes constitutional muster remains to be seen.

Wynne has — unusually for a U.S. state tax case — also attracted national media coverage in Canada and is being closely watched by Canadian tax practitioners. Like the United States, Canada is a federation in which the provinces have significant taxation powers, and although there are various intergovernmental agreements that aim to prevent the occurrence of double taxation of income by provinces, there is apparently little recourse available to a taxpayer should it actually occur.

Canada's provinces all impose income tax on taxpayers who reside in or conduct business from a permanent establishment in the province. As in the United States, it is possible for a taxpayer to be subject to income tax in more than one province, with double taxation being prevented through a network of intergovernmental agreements. Most provinces have structured their income tax to track the federal income tax regime and have contracted out their tax collection to the federal Canada Revenue Agency, which allocates income among the provinces in accordance with federal regulations generally regarded as uncontroversial. For the two provinces that collect their income taxes through their own revenue agencies (Québec and, for corporations only, Alberta), a memorandum of understanding for avoidance of double taxation of corporations among Québec, Alberta, and the CRA (on behalf of other provinces) provides a framework for all of Canada's tax agencies to resolve disputes about income allocation issues so as to prevent double taxation from occurring.

Although the existing network of agreements is generally effective at preventing double taxation (as evidenced by the near total lack of jurisprudence on the

[9] *Id.* at 22.

[10] *Id.* at 29.

subject), double taxation can potentially occur. Indeed, nothing (in principle) prevents Alberta or Québec from withdrawing from the MOU and refusing to resolve disputes over allocation matters through negotiation with other provinces. In such a case, the courts may have difficulty filling the void, given that provincial income taxes fall within the jurisdiction of the local courts and thus a taxpayer does not have a single tribunal where allocation disputes can be heard and resolved.

However, the provinces' taxation powers are circumscribed by the federal constitution — in particular by section 92(2) of the Constitution Act, 1867, which empowers provinces to impose direct taxation in the province. The lion's share of Canada's constitutional jurisprudence on provincial taxation powers has focused on whether a particular provincial tax is direct or indirect for the purposes of section 92(2). This said, the constitution also includes, at section 91(2), the trade and commerce clause — a provision that essentially grants the federal Parliament exclusive jurisdiction over the regulation of interprovincial commerce.

The trade and commerce clause has, in general, been interpreted more narrowly than the U.S. commerce clause and Canada has not developed a rule as wide-reaching as the dormant commerce clause south of the border. That said, the trade and commerce clause featured in the Supreme Court of Canada's decision in *CIGOL v Saskatchewan*, [1978] 2 SCR 545 — which invalidated a mineral income tax that Saskatchewan had sought to impose on oil and gas producers. A 7-2 decision of the Court held that since virtually all of the oil and gas produced in Saskatchewan was destined for export and since tax was set in such a way so as to fix the price received by producers, the mineral income tax constituted an improper attempt by Saskatchewan to regulate interprovincial trade and commerce in violation of the trade and commerce clause.[11]

Although U.S. jurisprudence is, of course, not binding on Canadian courts, it can be persuasive when it deals with previously unconsidered legal issues. A victory by the taxpayers in *Wynne* could invite a serious reflection in Canada of whether the trade and commerce clause, like the commerce clause in the United States, should be extended to create a constitutional barrier to the imposition of double taxation by provinces on a taxpayer's income.

IV. Analysis

Justice Scalia and Justice Clarence Thomas are expected to side with Maryland because of their previously articulated views on the dormant commerce clause (or, as Scalia calls it, the ''imaginary negative commerce clause'').[12] Maryland thus needs to pick up only three of the remaining judges to carry the day; and Kagan, Ginsburg, Sotomayor, Kennedy, and Breyer all expressed (to varying extents) some degree of sympathy with Maryland's core argument that *Wynne* has created an untenable situation in which individuals could, conceivably, be completely exempt from income tax in the state where they reside.

On the other hand, the Court also seemed prepared to accept that the problems created by *Wynne* could be remedied through a variety of alternative tax measures. More importantly, neither Maryland nor the United States seemed to offer a satisfying answer to the concern that the failure to provide a tax credit for out-of-state taxes constituted a de facto state tariff that deterred interstate commerce in favor of intrastate commerce — a concern raised repeatedly during oral arguments by Roberts, Alito, and Breyer. If the Court remains focused on this aspect of this case, it may be difficult for it to decide in favor of Maryland, given that protectionist measures from states clearly run afoul of the dormant commerce clause. Such a focus by the U.S. Supreme Court could also have an impact upon the subsequent discussion of the case in Canada, which has an express constitutional rule (section 121) against the imposition of tariffs and export duties between provinces.

Finally, the Court could potentially settle on a middle ground along the lines of the Maryland Court of Appeals dissent. The Court could accept the principle that because of the dormant commerce clause, a state does not have carte blanche to disregard income taxes paid by its residents in other states and thus impose ''pure'' double tax on all out-of-state income. However, it could hold that a state can legitimately provide only partial credit for out-of-state taxes paid so as to ensure that its residents bear their fair share of the burdens of local government. That Court might also hold that a person challenging such a partial credit regime under the dormant commerce clause has the onus to prove that it results in significant distortion of interstate commerce. Applying such a framework, the Court could potentially uphold Maryland's county income tax regime while also discouraging other states from following Maryland's example. ◆

[11]The Court also held that the mineral income tax was an indirect tax not authorized by section 92(2), which is the aspect of the decision that has become better known. *See* Transcript of Oral Argument, *supra* note 5, at 10.

[12]Justice Thomas did not ask questions during the *Wynne* hearing but is presumed sympathetic to Maryland's position, given his previous holding in his concurrence in *United Haulers Assn., Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330 (2007), that:

> the negative Commerce Clause has no basis in the Constitution and has proved unworkable in practice . . . [A]pplication of the negative Commerce Clause turns solely on policy considerations, not on the Constitution. Because this Court has no policy role in regulating interstate commerce, I would discard the Court's negative Commerce Clause jurisprudence.