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Comptroller v. Wynne: Internal Consistency, a National Marketplace, and Limits on State Sovereignty to Tax

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ESSAY

COMPTROLLER V. WYNNE: INTERNAL CONSISTENCY, A NATIONAL MARKETPLACE, AND LIMITS ON STATE SOVEREIGNTY TO TAX

MICHAEL S. KNOLL[†] AND RUTH MASON[‡]

INTRODUCTION

On November 12, 2014, the U.S. Supreme Court heard oral argument in *Comptroller of the Treasury v. Wynne*.[1] The case, which has already been called the Court's most important state tax case in decades,[2] asks how the dormant Commerce Clause restrains state taxation of individual income.[3] Because *Wynne* lacks the usual indicia of "certworthiness,"[4] the case raises the possibility that the Court will reshape the constitutional balance between the

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1 Comptroller v. Wynne, 134 S. Ct. 2660 (2014).

2 *See* Brannon P. Denning & Norman R. Williams, Wynne: *Lose or Draw?* 67 VAND. L. REV. EN BANC 245, 245 (2014) (noting that *Wynne* "may be the most important state tax case since . . . 1992" and citing David Sawyer, *Tax Observers Say* IBM *and* Wynne *Are Cases to Watch*, 73 ST. TAX NOTES 558 (2014) for support for the proposition from an Ernst & Young representative).

3 *See* U.S. CONST. art. I, § 8, cl. 3 (granting Congress the power "[t]o regulate commerce . . . among the several states").

4 *See* Michael S. Greve, *The Dormant Coordination Clause*, 67 VAND. L. REV. EN BANC 269, 270 (2014) ("All of the ordinary indicia of certworthiness—lower court splits, exceptional importance, and unsettled law—are missing here.").

states' sovereign interest in collecting taxes and the national interest in maintaining an open economy.

The challenge for the Court, whose dormant Commerce Clause rulings have attracted intense criticism,[5] is to delineate clear limits on state taxation that promote a national market economy without unduly restricting the states' taxing authority. In earlier writings, we developed a framework to resolve tax discrimination cases in a consistent and intuitive manner that provides states with broad flexibility while maintaining an open interstate market.[6] In this Essay, we apply that framework to *Wynne* to demonstrate how Maryland's current system violates the dormant Commerce Clause. We also describe how our approach addresses Maryland's arguments and resolves many issues that seemed to trouble the Justices at oral argument.

The rest of this Essay proceeds as follows. After providing the factual and legal background of the case, we show that the contested Maryland income tax regime fails the Court's long-standing internal consistency test and so would be struck down were the Court to apply that test. We then respond to Maryland's three major arguments why the Court should not apply the internal consistency test. Drawing on our earlier work, we first show that Maryland's principal claim, that its tax law does not discourage cross-border commerce because residents are taxed at the same rate on in-state and out-of-state income, whereas non-residents are taxed at a lower rate on in-state income and not at all on out-of-state income, is not dispositive. Maryland's argument should not prevail because economic analysis shows that the comparison of tax rates that Maryland offers is too simplistic to reveal whether the Maryland tax system discourages cross-border commerce. Second, Maryland claims that any interference with the Wynnes' cross-border commerce stems from the interaction of different states' tax systems rather than Maryland's tax regime alone. This claim is wrong, and we show that Maryland's tax system would burden interstate commerce even if no other state imposed taxes. Third, we show that Maryland's claim that a decision for the taxpayer

5 *See, e.g.*, Wardair Can., Inc. v. Fla. Dep't of Revenue, 477 U.S. 1, 17 (1986) (Burger, C.J., concurring in part and concurring in the judgment) (referring to "the cloudy waters of this Court's 'dormant Commerce Clause' doctrine"); Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450, 458 (1959) (referring to dormant Commerce Clause doctrine as a "quagmire"); Dan T. Coenen & Walter Hellerstein, *Suspect Linkage: The Interplay of State Taxing and Spending Measures in the Application of Constitutional Antidiscrimination Rules*, 95 MICH. L. REV. 2167, 2173 (1997) (describing the doctrine as in need of a "principled approach"); Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 929 (1992) (describing the doctrine as "slippery").

6 Our work focused on European Union law, which includes tax nondiscrimination principles similar to those imposed by the Constitution. Ruth Mason & Michael S. Knoll, *Waiting for Perseus: A Sur-Reply to Graetz and Warren*, 67 TAX L. REV. 375 (2014); Ruth Mason & Michael S. Knoll, *A Brief Sur-Reply to Professors Graetz and Warren*, 123 YALE L.J. ONLINE 1 (2013); Ruth Mason & Michael S. Knoll, *What Is Tax Discrimination?*, 121 YALE L.J. 1014 (2012).

would allow residents with out-of-state income to free-ride on Maryland's public services is overstated because the internal consistency test provides states with wide flexibility to tax.

The arguments in *Wynne* largely followed the outline above, with an important exception. The taxpayer argued that the dormant Commerce Clause requires Maryland to eliminate double taxation of their interstate commerce for the simple reason that Maryland is their state of residence. But the Court's dormant Commerce Clause doctrine does not clearly support the interpretation that the state of residence must eliminate double taxation. Nor is such an interpretation needed for the Wynnes to win their case. Rather than requiring elimination of double taxation, the dormant Commerce Clause prohibits states from discriminating against interstate commerce. We show that Maryland discriminates against interstate taxation, and this discrimination would persist even if no other states imposed taxes. It is, therefore, independent of any double taxation that arises under the Maryland tax, and it is also independent of any action other states take. Double taxation is not the focus of the dormant Commerce Clause, and avoiding double taxation is not the same as not discouraging cross-border commerce. As we show, a state can discourage cross-border commerce even though there is no double taxation, and double taxation can occur without discouraging cross-border commerce.

I. FACTUAL AND LEGAL BACKGROUND

For nearly two hundred years, the Supreme Court has interpreted the dormant Commerce Clause to invalidate a broad array of state laws that discourage interstate commerce.[7] The Court has long recognized, that the dormant Commerce Clause prevents states from "Balkanizing" the national market (dividing the national market into a collection of separate state markets), and bars efforts by the states to enact protectionist legislation that favors in-state over interstate commerce.[8]

7 *See* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW 456 (2009) (tracing the dormant Commerce Clause back to *Gibbons v. Ogden*, 22 U.S. 1 (1824)); *see also* Wyoming v. Oklahoma, 502 U.S. 437, 454 (1992) ("It is long established that, while a literal reading evinces a grant of power to Congress, the Commerce Clause also directly limits the power of the States to discriminate against interstate commerce.").

8 *See* Hughes v. Oklahoma, 441 U.S. 322, 325 (1979) ("[I]n order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation."). However, Justices Scalia and Thomas are skeptical of the dormant Commerce Clause. Barry Friedman & Daniel T. Deacon, *A Course Unbroken: The Constitutional Legitimacy of the Dormant Commerce Clause*,

In common parlance, the dormant Commerce Clause promotes a level playing field between in-state and out-of-state actors. Thus, a state tax that favors in-state commerce over interstate commerce violates the Commerce Clause.[9] A state tax can tilt the playing field in favor of domestic commerce in either of two ways. First, it may disadvantage nonresidents as compared to residents in the competition to earn domestic income. Second, it may disadvantage residents as compared to nonresidents in the competition to earn income in other states.[10] A tax that discourages cross-border commerce in these ways discriminates against interstate commerce.

In order to demonstrate the Court's current approach to tax discrimination, we turn to the facts of *Wynne*. Respondents, Brian and Karen Wynne, a married couple and residents of Maryland, own stock in Maxim Healthcare Services, Inc. (Maxim), a Maryland corporation that engages in business throughout the United States.[11] Maxim, because it elected S-corporation status, does not pay federal income tax.[12] Instead, Maxim passes through to its shareholders all items of income and expense (including states tax paid).[13] Maxim's shareholders, including the Wynnes, report their pro rata share of those items on their personal federal income tax returns.[14]

Maryland formally divides its individual income tax into a "state" portion with a maximum rate of 4.75%, and a "county" portion with rates ranging

97 VA. L. REV. 1877, 1878-80 (2011). In their view, only Congress has the power to eliminate state laws that burden interstate commerce. *Id.*

9 There is a wealth of literature, with its own vocabulary, on how taxation can distort commerce. A tax system is said to promote capital ownership neutrality when it does not distort who owns capital. In contrast, a tax system is said to promote capital export neutrality when it does not distort where capital is located. The dormant Commerce Clause is concerned with ownership, not the location of activity. We use the phrase discouraging interstate commerce relative to in-state commerce (and the shorthand discouraging interstate commerce) to refer to distortions of ownership, not location.

10 Under the Court's doctrine, "reverse discrimination" (that is, tax policies that either advantage residents as compared to nonresidents in the competition to earn domestic income or advantage nonresidents as compared to residents in the competition to earn income in other states) is not unconstitutional.

11 Md. State Comptroller v. Wynne, 64 A.3d 453, 459 (Md. 2013), *cert. granted*, 134 S. Ct. 2660 (2014).

12 *Id.*

13 *Id.*

14 Maryland follows federal tax law in treating S corporations as pass-through entities. *Id.* at 457-60.

from 1.25% to 3.2%.[15] Maryland collects both portions of the tax, but it remits the "county" portion to the counties.[16]

Maryland allows taxes paid to other states to fully offset the "state" portion of the tax, but it disallows any credit against the "county" tax.[17] Ignoring the uncontested "state" portion of the tax, the Maryland tax regime contains the following elements:

For residents:

1. On income earned in Maryland, a "county" tax of 1.25% to 3.2%, depending on the county of residence (domestic tax or T_d) [18]
2. On income earned in other states, a "county" tax of 1.25% to 3.2%, depending on the county of residence (outbound tax or T_o) [19]

For nonresidents:

3. On income earned in Maryland, a "county" tax of 1.25% (Maryland calls this the Special Non-Resident Tax or SNRT; we call it the inbound tax or T_i)[20]
4. On income earned in other states, no tax.

The Wynnes resided in Howard County, where the "county" tax rate was 3.2%, so the Wynnes paid "county" tax of 3.2% on their domestic and outbound income. Table 1 schematically represents the Maryland "county" tax regime for Howard County.

15 MD. CODE ANN., TAX-GEN. §§ 10–102 to 10–106 (West 1998) (amended 2013). The 1998 rates listed above, codified in § 10–105, were in force in 2006, the year at issue in *Wynne*.

16 In a prior case, the Maryland Court of Appeals held that the Maryland "county" tax was a state tax for constitutional law purposes, and no party contests that issue in *Wynne*. Frey v. Comptroller, 29 A.3d 475, 492 (Md. 2011), *cert. denied*, 132 S. Ct. 1796 (2012).

17 MD. CODE ANN., TAX-GEN. § 10–703(a) (West, Westlaw through 2014 Sess.).

18 Md. Code Ann., Tax-Gen. § 10–103(a)(1) (West, Westlaw through 2014 Sess.).

19 *Id.*

20 Md. Code Ann., Tax-Gen. § 10–106.1(a) (West, Westlaw through 2014 Sess.). This rate varies to match the lowest rate set by any county. *Id.*

Table 1: Maryland "County" Tax Regime

	Maryland Resident	Resident of Another State
Activity in Another State	Outbound Tax, T_o 3.2%	N/A
Activity in Maryland	Domestic Tax, T_d 3.2%	Inbound Tax, T_i 1.25%

II. MARYLAND'S TAX REGIME IS INTERNALLY INCONSISTENT

At the center of many dormant Commerce Clause cases, including *Wynne*, is the internal consistency test.[21] Under that test,

> [i]nternal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear. This test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate.[22]

Thus, the internal consistency test directs a court to assume every state enacts the challenged state's tax regime, and then asks whether, under such hypothetical harmonization, interstate commerce is taxed more heavily than purely in-state commerce. Table 2 shows how income would be taxed if every state (represented here by Delaware) adopted the Maryland "county" tax as employed in Howard County:

21 *See* Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983) (articulating requirement of internal consistency); JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 4.16 (3d ed. 2013) (noting that the Court has extended the internal consistency test so that it is "a more general rule barring taxes that discriminate against interstate commerce").

22 Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995).

Table 2: Maryland Tax Under the Internal Consistency Test

	Maryland Resident	Delaware Resident
Activity in Delaware	4.45%	3.2%
Activity in Maryland	3.2%	4.45%

As Table 2 shows, the Maryland "county" tax is internally inconsistent because domestic income (unshaded quadrants) would be taxed at only 3.2% (the domestic tax rate), whereas cross-border income (shaded quadrants) would be taxed at 4.45% (the sum of the outbound and inbound tax rates). Based on similar reasoning, the Maryland Court of Appeals concluded that the Maryland tax regime violated the dormant Commerce Clause and ordered the Maryland legislature to remedy the violation, but left to the legislature the choice of method.[23]

III. MARYLAND'S DEFENSES

Recognizing that Maryland fails the internal consistency test, the Maryland Comptroller, the federal government, and other amici supporting Maryland urge the Court not to apply that test.[24] They offer three main arguments. First, they argue that the Maryland tax does not discriminate against cross-border commerce.[25] Second, they argue that if cross-border commerce involving Maryland is discourage, that discouragement arises because of the interaction of Maryland's tax with other states' taxes and is not the fault of Maryland.[26] Third, they argue that Maryland's need for money and the duty of residents, such as the Wynnes, who consume services in Maryland to pay tax to Maryland should take precedence over any burden on interstate commerce.[27] We address each of these defenses in turn.

23 Md. State Comptroller v. Wynne, 64 A.3d 453, 471, 478 (Md. 2013), *cert. granted*, 134 S. Ct. 2660 (2014).

24 *See, e.g.*, Brief for Petitioner at 38, Comptroller of the Treasury v. Wynne, No. 13-485 (U.S. July 29, 2014) (arguing against the use of the internal consistency test).

25 *Id.* at 33-37.

26 *Id.* at 26-27.

27 *Id.* at 20-24.

A. *No Discrimination*

According to Maryland and its supporters, Maryland's state tax system does not violate the dormant Commerce Clause because the tax does not unduly burden interstate commerce. On the contrary, they argue that the Maryland tax regime either encourages or is neutral toward interstate commerce. As the Comptroller points out, Maryland taxes residents at the same rate on their domestic and out-of-state incomes (3.2%), and it taxes nonresidents on their Maryland-source income at lower rates than it taxes residents (1.2% versus 3.2%). Thus, asks the Comptroller, where is the discrimination?[28]

To answer that question, we draw on a series of articles we have published in recent years. The central issue in state tax cases involving the dormant Commerce Clause (including *Wynne*) is whether a state's tax system discourages interstate commerce.[29] If a challenged tax discourages interstate commerce in favor of domestic commerce, then it is unconstitutional. The import of our analysis is that determining whether a tax system is neutral between in-state and interstate commerce requires consideration of how a state taxes residents and nonresidents on *both* in-state and out-of-state income. Our principal result can be expressed as requiring that all taxes be assessed on either a *uniform source* or a *uniform residence* basis.[30] A source tax is uniform if it applies at the same rate and on the same base[31] to both residents' and nonresidents' income from the state. A residence tax is uniform if it applies at the same rate and on the same base to residents' in-state and out-of-state income. Accordingly, if a state taxes on both a source and residence basis, it must apply both source and residence taxes to its residents' in-state income.[32]

In the special case where the challenge is only to a tax system's rates (not to the tax base or to the calculation of taxable income), the above rule reduces to a simple mathematical formula. The requirement that both source and residence taxes apply to a state's taxation of its own residents (coupled with a recognition that the dormant Commerce Clause prohibits states from discouraging cross-border commerce, but does not prohibit them from encouraging such commerce) implies that the non-discouragement condition is an inequality. Specifically, in order for a state's taxes not to discourage interstate

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28 *See* Transcript of Oral Argument at 4, Comptroller of the Treasury v. Wynne, No. 13-485 (U.S. Nov. 12, 2014) ("[A]ll residents are treated the same. They are taxed on their entire income regardless of where it is earned." (statement of William F. Brockman, counsel for the Comptroller)).

29 The issue is essentially the same in cases brought at the Court of Justice of the European Union involving the free movement rights under the EU treaties. Mason & Knoll, *What is Tax Discrimination?*, *supra* note 6, at 1085-97.

30 *See id.* at 1060-74 (describing uniformity requirements for taxes not to distort competition).

31 "Tax base" refers to the rules for calculating taxable income.

32 *See* Mason & Knoll, *What is Tax Discrimination?*, *supra* note 6, at 1061-67.

commerce the tax rate assessed by a state on its residents' domestic source income, T_d, must equal or exceed the combined tax imposed on residents' out-of-state income, T_o, and nonresidents' in-state income, T_i. Arithmetically, this can be written as follows:

Equation 1

$$T_d \geq T_o + T_i - (T_o \times T_i)$$

That is, the tax rate applied to the domestic income of residents must equal or exceed the sum of the tax rates paid by residents on out-of-state income and by nonresidents on domestic income less the product of those two rates. If a state's tax rates do not satisfy Equation 1, its tax system discourages interstate competition.[33] Notice that Equation 1 does not specify the rates—rather it specifies the relationship among the rates. A state may set its tax rates as high or low as it wants. Moreover, a state has flexibility to set any two tax rates it chooses, but given any two of the rates, the third rate is constrained. Thus, the dormant Commerce Clause prevents a state from setting its tax on domestic income independently from its tax on interstate (inbound and outbound) income.

This approach is based on a solid economic foundation.[34] Residents of high-tax states (such as California and New York) hold many investment assets in spite of being taxed more heavily on those investments than many potential investors from lower-taxed states (such as Florida). But high taxes alone do not discriminate against interstate commerce, although they may generate other distortions, including discouraging commerce generally.

It is common and (to most non-economists) intuitive to assume that the impact of taxes on competition in a specific market can be assessed by simply comparing competitors' tax rates within that market. But that intuition is wrong. To determine the impact of Maryland's taxes on interstate competition, we need to look beyond Maryland, and we must engage in a more complex comparison.

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33 *See* Mason & Knoll, *Waiting for Perseus*, *supra* note 6, at 436-41 (providing a derivation of non-distortion conditions); *see also* Ryan Lirette & Alan D. Viard, *State Taxation of Interstate Commerce and Income Flows: The Economics of Neutrality* 23 (Am. Enter. Inst. Econ. Policy, Working Paper 2014-07, 2014).

34 Our approach is based on portfolio theory, especially the theory of portfolio choice in an environment with taxes. *See, e.g.*, M. J. Brennan, *Taxes, Market Valuation and Corporate Financial Policy*, 23 NAT'L TAX J. 417, 420 (1970) (describing the effect of varying marginal tax rates on investment selection).

In order to describe that comparison we introduce some notation. A retention rate is the share of before-tax income a taxpayer retains in a given market after paying taxes, and a retention ratio is the ratio of retention rates across markets for a given taxpayer. The competitive position of an economic actor considering working or investing in a particular market is determined not by a simple comparison, but rather through a three-step process. First, determine how *that actor is taxed in the particular market* under consideration relative to how that actor is taxed in alternative markets. Second, determine how that actor's *competitors are taxed in the particular market* relative to the alternative markets. Third, determine how a state's taxes impact cross-border commerce by comparing the previous two comparisons, that is, compare how the actor is taxed in the relevant market relative to alternative markets as compared to competitors.

Accordingly, even if Maryland taxes nonresidents less heavily than residents on income earned in Maryland, it does not follow that Maryland provides nonresidents with a tax-induced competitive advantage over residents for income earned in Maryland. Rather, an actor has a tax-induced competitive advantage in a particular market over a second actor only if the share of pre-tax income retained by the first actor in that market relative to the share of pre-tax income retained by that actor in other markets exceeds that same ratio for the second actor. That is to say, an actor has a tax-induced competitive advantage over a second actor in a specific market only if the first actor's retention ratio in that market exceeds the second actor's retention ratio in that same market.

This rule can be applied to the Maryland "county" income tax. In order to isolate the effect of Maryland's "county" tax, consider a hypothetical in which no state other than Maryland taxes income, and Maryland apples only its "county" tax. Maryland residents would pay the same 3.2% tax on in-state and out-of-state income, and thus retain 96.8% of their before-tax income in both categories (*retention rate* of 96.8%). The *retention ratio* for Maryland residents on instate income as opposed to out-of-state income is 1. In contrast, Maryland nonresidents pay 1.25% tax on their Maryland income and so retain 98.75% of their Maryland income, whereas they retain 100% of their non-Maryland income (given our assumption that no other state imposes income taxes). Thus, nonresidents enjoy a retention ratio of 98.75% on their Maryland income relative to their non-Maryland income.

In our example, Maryland nonresidents have a higher retention rate than residents for both in-state and out-of-state income.[35] This is not the end of

35 When they invest outside of Maryland, nonresidents retain 100% of their pre-tax income whereas Maryland residents retain only 96.8%; when they invest in Maryland, nonresidents retain 98.75% whereas residents retain 96.8%.

the story, however. Although nonresidents always retain more than Marylanders, nonresidents retain a *relatively smaller* portion of their *Maryland income* than do residents as compared to the portion they retain when they earn income outside Maryland, as seen in nonresidents' lower retention ratio. Nonresidents (who are taxed at 1.25% on their in-state income and not at all on their out-of-state income) retain 98.75% as much of their before-tax income when they earn income in Maryland as opposed to when they earn income outside of Maryland. In contrast, Maryland residents (who are taxed at 3.2% everywhere and so retain 96.8% of their income regardless of where they earn it) retain the same portion of before-tax income everywhere. Thus, because nonresidents have a smaller retention ratio than residents (98.75% and 100%, respectively) and thus retain a smaller proportion of their income when their income is earned within Maryland relative to outside Maryland as compared to residents, nonresidents are at a tax-induced competitive disadvantage *relative to Maryland residents* in Maryland. Conversely, because residents retain a smaller proportion of their non-Maryland income relative to their Maryland income (101.27%), residents are at a tax-induced competitive disadvantage *relative to nonresidents* outside Maryland.[36]

Notice that the distortion to competition operates in two opposing directions. Maryland's tax regime simultaneously discourages Maryland residents from engaging in commercial activity *outside* of Maryland, and it discourages nonresidents from engaging in commercial activity *inside* of Maryland. Competitive distortions often feature two such opposing distortions. The distortion works in a different direction depending on the residence state of the taxpayer. If the taxpayer is a Maryland resident, the Maryland regime discourages her from earning out-of-state income. On the other hand, if the taxpayer is a nonresident, the Maryland regime discourages her from earning Maryland income. Such market segmentation—and in particular the differential effects that depend on the taxpayer's state of residence—is precisely the kind of mischief the dormant Commerce Clause is meant to prevent.[37]

36 The above condition can be expressed algebraically by the following equation, which is equivalent to Equation 1:

$$\frac{(1-T_d)}{(1-T_o)} \leq \frac{(1-T_i)}{1}$$

37 *See* Ian Roxan, *Assuring Real Freedom of Movement in EU Direct Taxation*, 63 MOD. L. REV. 831, 846-49 (2000) (describing the European Union free movement rights as concerned with preventing state tax policies that would encourage residents of different member states to move in opposite directions).

Other types of tax-induced distortions lack this feature. Locational distortions tend to operate in the same direction for both residents and nonresidents. For example, a Maryland source tax will discourage *both residents and nonresidents* from engaging in commercial activity *in Maryland* in favor of engaging in such activity outside Maryland in a place with no or lower source taxes.

The above discussion might seem technical and obscure, but it is central to *Wynne* and most dormant Commerce Clause tax cases because the key inquiry in such cases is whether a state's tax system impedes cross-border commerce relative to in-state commerce. In contrast with the internal consistency test and the above analysis, the Comptroller urges the Court to compare Maryland's tax on domestic transactions only to Maryland's tax on inbound transactions.[38] Such an approach leads to a wrong result because it improperly ignores the role taxes in other markets play in ascertaining how taxes affect competition. Economic analyses show that simple tax rate comparisons across competitors in a single market (such as those the Comptroller offers) are misleading. More complex comparisons across *both* markets and competitors are required to determine whether a state's taxes distort competition between residents and nonresidents.[39]

Furthermore, notice that in the absence of tax credits, the internal consistency test, Equation 1, and the uniformity principle are equivalent and yield the same result. In other words, the internal consistency test is not ad hoc or arbitrary, but has a solid economic foundation.

B *The Question of Fault*

Although it is uncontested that the Wynnes paid higher taxes because they had out-of-state income than they would have paid on a comparable amount of purely domestic income, Maryland argues that its tax system does not discourage cross-border commerce. Maryland attributes the Wynnes' higher tax burden to other states' taxes. According to Maryland, any cross-border disadvantage "arises from the combination of the income taxes of two States,"[40] so there is no basis to penalize Maryland.[41]

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38 Expressed mathematically, Maryland would write the non-distortion condition as

$$T_d \geq T_i \textit{ and } T_d \geq T_0$$

or equivalently as

$$(1 - T_d) \leq (1 - T_i) \textit{ and } (1 - T_d) \leq (1 - T_o).$$

39 *See* Mason & Knoll, *Waiting for Perseus*, *supra* note 6, at 436-41 (deriving these principles).

40 Transcript of Oral Argument, *supra* note 28, at 22.

41 Justice Breyer would seem to agree. *Id.* at 23 ("I don't see anybody at fault.").

Nonetheless, as described above, Maryland's tax system discriminates against interstate commerce by favoring residents over nonresidents in earning income in Maryland while simultaneously favoring Maryland residents over nonresidents in earning income outside Maryland. We showed earlier that *even if no other state imposes any tax*, Maryland's tax system upsets competition between Marylanders and nonresidents, both inside Maryland and outside of it.[42] Thus, Maryland's tax system discriminates against interstate commerce regardless of other states' taxes.

C. *Revenue Argument*

Maryland argues that if, as the taxpayer requests, Maryland were to credit taxes paid to other states against the "county" tax, then the Wynnes (or other residents with only outbound income) could end up paying no Maryland tax in spite of receiving substantial benefits from Maryland.[43] Thus, the Comptroller suggests that a decision for the Wynnes would allow the Wynnes to free ride off of Maryland taxpayers and prevent Maryland from collecting the taxes it needs to provide services. Both claims are questionable.

If Maryland were to grant a credit up to the Maryland county tax (a full credit) as the taxpayer requests, the Wynnes would not enjoy a windfall. A properly designed worldwide tax with a full credit ensures that a resident with out-of-state income pays at least as much tax as would be due domestically, but never less.[44] Thus, even if the Wynnes prevailed, their tax burden would not be lower than that of other Marylanders with comparable income.

In addition, the claim that Maryland would not collect all the revenue it should if it had to credit other states taxes against the "county" tax is also questionable. Recall that Maryland's claim is premised on the assumption

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42 *See supra* Section III.A.

43 Brief for Petitioner, *supra* note 24, at 23 ("[A] Maryland resident earning all of her income in other states might well have no obligation to pay any Maryland income tax at all . . . ."). This argument seemed to resonate with some of the Justices. Justice Ginsburg asked about a hypothetical in which "[a] Maryland resident owes nothing to Maryland . . . [even though he] may have five children that he sends to school in Maryland." Transcript of Oral Argument, *supra* note 28, at 29. Justice Kennedy characterized the hypothetical as "a free ride off Maryland school." *Id.* at 30.

44 There are two possible scenarios with a full tax credit. First, if the source state tax rate is less than the residence state tax rate, the state of residence will tax the income bringing the total tax up to the tax that would be collected if the income were sourced in the residence state. Second, if the source state tax rate is equal to or greater than the residence state tax rate, the state of residence will not tax the income, but it will not provide a refund, in which case the taxpayer pays at least as much tax (and possibly more tax) as if the income were sourced in the residence state.

that the Wynnes (and other residents with out-of-state income) would consume state services without paying the full amount of Maryland taxes. But Maryland collects revenue from nonresidents who earn income in Maryland, even though those nonresidents use only limited Maryland services (presumably, nonresidents consume more services in their states of residence than in Maryland). Thus, Maryland's revenue loss is limited to the extent by which Marylanders' out-of-state income exceeds nonresidents' in-state income. For most states, any windfall or shortfall is likely to be small compared to its total tax collections or budget.

Maryland's argument that it should not have to provide a full credit misses the point. As Equation 1 makes clear, Maryland can, consistent with the dormant Commerce Clause, continue to tax Maryland residents' out-of-state income *without offering any credit at all*. Because Maryland has flexibility to set any two tax rates however it chooses, it could leave any two of its three current rates unchanged. For example, Maryland could retain its 3.2% tax on residents' out-of-state income (with no credit) as well as its 1.25% tax on nonresidents' Maryland income and cure the violation by increasing the tax rate on its own residents' domestic income to 4.41%.[45] Alternatively, Maryland could retain both its 3.2% tax on residents' domestic income and its 1.25% tax on nonresidents' in-state income but cure the violation by reducing the tax on its residents' out-of-state income to 1.97%.[46] Still another option would be for Maryland to adjust any two or possibly all three taxes so long as the domestic tax rate equaled (or exceeded) the combined inbound and outbound tax rates, as seen in Equation 1. In other words, there are many ways for Maryland to collect tax revenue on the out-of-state income of its residents without violating the internal consistency test.[47]

What Maryland cannot do, consistent with the dormant Commerce Clause, is simultaneously maintain its 3.2% tax on residents' out-of-state income with no credit, its 1.25% tax on nonresidents' Maryland income, and its 3.2% tax on residents' domestic income. Such a tax system discourages cross-border commerce, as clearly demonstrated by the failure of the tax regime to pass the internal consistency test. Upholding the Maryland Court of Appeals therefore would not preclude Maryland from taxing the Wynnes (as well as other Maryland residents who earn all of their income outside of Maryland

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45 The domestic tax (4.41%) is the total tax from combining a 3.2% source tax with a 1.25% residence tax and subtracting source taxes from residence income. That is to say:

$$4.41\%(T_d) = 3.2\%(T_o) + 1.25\%(T_i) - 3.2\% \times 1.25\%$$

46 The domestic tax (3.2%) is the total tax from combining a 1.97% source tax with a 1.25% residence tax.

47 Maryland can also raise tax revenue with other taxes, such as real property taxes and sales taxes, so long as those taxes are internally consistent.

in high-tax states) in order to ensure that they help to pay for Maryland services, but it would require Maryland to tax in a manner that satisfies the dormant Commerce Clause by not unconstitutionally hindering interstate competition.

IV. Distinguishing Double Taxation from Discrimination

The discussion above presents our argument for striking down the Maryland "county" income tax and shows why the Comptroller's arguments in favor of upholding that tax fall short. The taxpayer, however, frames the case (and the Court's dormant Commerce Clause tax doctrine) not as asking whether Maryland's "county" tax discriminates against interstate commerce, but rather as asking whether the Constitution requires Maryland to relieve double taxation.[48] That framing is problematic for the taxpayer because it provides the Comptroller with strong counterarguments, which the Wynnes' counsel struggled to address in oral argument. Maryland argues that the Constitution does not forbid double taxation,[49] and further, that the Constitution includes no priority rule for determining whether the source state or the residence state must relieve double taxation if it occurs.

Some of the questions asked by the Justices at oral argument suggest that they too see the taxpayer's position in *Wynne* as raising a "priority rule" question and they are skeptical that the Constitution mandates any particular rule.[50] In our view, *Wynne* and the dormant Commerce Clause do not require a priority rule between source and residence states' taxes. That is because the dormant Commerce Clause does not forbid double taxation per se, but rather

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48 Brief for Respondents at i, Comptroller of the Treasury v. Wynne, No. 13-485 (U.S. Sept. 19, 2014) (posing the question presented as "[w]hether a state tax that exposes interstate commerce to double taxation is saved from invalidation under the Commerce Clause merely because the State imposes the tax upon its own residents"). Several amici supporting respondent also frame the issue in terms of double taxation. *See, e.g.*, Brief of the Chamber of Commerce of the United States as Amicus Curiae at i, Comptroller of the Treasury v. Wynne, No. 13-485 (U.S. Sept. 26, 2014) (same); Brief of the Md. Chamber of Commerce as Amicus Curiae at 5, Comptroller of the Treasury v. Wynne, No. 13-485 (Sept. 26, 2014) (referring to "[t]he well-established dormant Commerce Clause principles protecting interstate commerce from multiple taxation").

49 For example, when asked whether double taxation of the same income by California and Hawaii would be constitutional, Maryland's lawyer responded that it would be. Transcript of Oral Argument, *supra* note 28, at 6.

50 *See, e.g.*, *id.* (Scalia, J.) ("Why is it that the State that taxes all the income of its residents has to yield rather than the State that taxes all income earned in the State?"); *see also id.* at 10 (Ginsburg, J.) ("Do you stop having the power to tax worldwide income because other States may tax on a different [source] basis?"); *id.* at 36 (Kagan, J.) (inquiring as to what the Constitution requires if some states tax on residence and others on source, leading to substantial double taxation).

prohibits states from discouraging interstate commerce by advantaging residents over nonresidents in the competition to earn in-state income and prevents states from advantaging residents over nonresidents in the competition to earn out-of-state income.

Economic analysis generates specific prescriptions for preventing such distortions: namely, states must comply with the rate rule in Equation 1. Those prescriptions are at best tangentially related to a prohibition on double taxation. Double taxation is not a necessary condition for tax discrimination—a state can discriminate against cross-border commerce without imposing double taxation. For example, if Maryland were the only state to tax and enacted a 3.2% tax rate on residents' in-state income coupled with a 5% tax on nonresidents' in-state income, Maryland would discriminate against cross-border commerce even though double taxation would be completely absent. Conversely, not all instances of double taxation are discriminatory. For example, if Maryland adopts a uniform 5% source tax and Delaware adopts a uniform 8% residence tax, then there will be wide divergence in the number of times a given person is taxed (none, once, or twice) and in the total tax rate (0%, 5%, 8%, and 12.6%). Nonetheless, as long as both taxes are uniform, they will not distort competition.[51]

The Comptroller and several Justices seized on the taxpayer's claim that the dormant Commerce Clause prohibits double taxation. They argue that the taxpayer's theory of the case would require the Court to create or derive from the Commerce Clause a priority rule that dictates which state—source or residence—ought to relieve double tax so that no taxpayers are taxed by more than one jurisdiction.

When asked at oral argument whether the dormant Commerce Clause encompasses a priority rule, the Wynnes' lawyer argued that the Court's doctrine establishes a source-state priority rule, under which the residence state must yield.[52] Such a rule would reflect near-universal state practice of granting credits at residence,[53] as well as international practice of crediting or exempting at residence. Nevertheless, the best reading of the apportionment cases, and particularly the Court's unwillingness in *Moorman Manufacturing*

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51 The tax system does not distort competition even though Delaware residents are taxed more heavily than are Maryland residents, regardless of where they earn income, because Maryland and Delaware residents both retain 95% as much when they earn income in Delaware than when they earn income in Maryland under the retention ratio analysis.

52 Transcript of Oral Argument, *supra* note 28, at 35-36.

53 *See id.* at 32 (noting that, except for Maryland, all other states with broad-based income taxes—totaling 42 states—grant credits for other states' source taxes).

Co. v. Bair to choose between internally consistent corporate income apportionment formulas, is that the dormant Commerce Clause provides no guidance as to how to choose among different internally consistent taxes.[54]

Although the Wynnes are correct that the Court's precedent more strongly supports the notion of source (over residence) priority to tax, there is no reason that the Court has to locate a priority rule in the dormant Commerce Clause in order to resolve the case in their favor. Rather, all that is required is that the state exercise tax jurisdiction on legitimate bases (source and residence) and that all taxes be uniform on a source or residence basis. In other words, the state's taxes must be internally consistent.

CONCLUSION: THE STAKES

Although *Wynne* only directly implicates the Maryland "county" tax, the stakes are larger. If Maryland prevails, Maryland might eliminate the credit on that portion of its tax it labels the "state" tax. Other states could follow suit and eliminate their credits, severely curtailing cross-border commerce. The Court through *Wynne* must not give the states the tools to "Balkanize" the national economy, reversing 200 years of legal and economic policy. A simple way for the Court to reinforce the idea of a single, integrated national economy is to back away from its recent practice of narrowing the application of the internal consistency test[55] and to uphold the Maryland Court of Appeals' decision in *Wynne* explicitly on the grounds that Maryland's tax system fails the internal consistency test.

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54 *See* Moorman Mfg. Co. v. Bair, 437 U.S. 267, 281 (1978) (holding that Iowa's single-factor apportionment formula, which allocated corporate income among the states based on sales, was constitutional even though most states allocated income using a three-factor formula, the arithmetic average of sales, capital and payroll, because it was not the Court's role to choose among alternative constitutionally permissible regimes).

55 *See* HELLERSTEIN & HELLERSTEIN, *supra* note 21, ¶ 4.16[1][d] (noting that while the Court has not invalidated a state tax on the grounds of internal consistency since 1987, state courts regularly do so).