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Wynne: It's Not About Double Taxation

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In this article, the authors discuss the U.S. Supreme Court's dormant commerce clause jurisprudence regarding state tax challenges. They argue that Maryland's tax scheme, which is the subject of a Supreme Court challenge, violates internal consistency, and they use economic analysis to illustrate problems with the state's arguments in the case.

The authors have benefited from presentations at the Mannheim Taxation ScienceCampus and Northwestern and UVA law schools. This article draws on their amicus brief in *Wynne*.

I. Introduction

On November 12, 2014, the U.S. Supreme Court heard oral arguments in *Wynne v. Comptroller*[1] on grant of certiorari from the Maryland Court of Appeals.[2] The case, which is a rare state tax discrimination case to reach the Supreme Court,[3] presents an opportunity for the Court to rationalize its dormant commerce clause jurisprudence. That jurisprudence has attracted intense criticism from commentators.[4] The Supreme Court has labeled its own tax discrimination jurisprudence a "quagmire" and "tangled underbrush."[5]

We use economic analysis to show that Maryland's tax regime discriminates against interstate commerce. We also argue that the parties' framing of the central issue in the case — whether the Constitution requires states to relieve double taxation — draws focus away from the discrimination question and could undermine the Wynnes' case and lead to unjustified narrowing of the dormant commerce clause. We also show how our approach to tax discrimination resolves many of the issues that seemed to trouble the justices at oral argument.

II. Economic Analysis of the Dormant Commerce Clause

A. The Dormant Commerce Clause Requires Competitive Neutrality

States violate the dormant commerce clause when they encourage in-state commerce at the expense of interstate commerce. The comparison embedded in that statement is important. The Constitution does not prevent states from discouraging commerce generally, as any tax that falls on commerce may discourage it. Thus, the dormant commerce clause does not prevent a state from taxing all income earned within the state even though such a tax will discourage both residents and nonresidents from earning income within the state.[6] The clause also does not prevent a state from taxing all income (both in-state and out-of-state) earned by residents even though such a tax might discourage residents from engaging in income-generating activity.[7]

Our view is that the Supreme Court interprets the dormant commerce clause to require what we call competitive neutrality, or a level playing field between in-state and interstate commerce.[8] Competitive neutrality has two requirements: (1) A state cannot provide residents with an

[1] Docket No. 13-485.

[2] *Comptroller of the Treasury v. Wynne*, 64 A.3d 453 (Md. 2013), *cert. granted*, 134 S. Ct. 2660 (2014).

[3] Michael S. Greve, "The Dormant Coordination Clause," 67 *Vand. L. Rev. En Banc* 269, 270 (2014) (noting that the Supreme Court has decided only five state tax discrimination cases under the dormant commerce clause since 1997).

[4] *See, e.g.*, Dan T. Coenen and 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).

[5] *Nw. States Portland Cement v. Minnesota*, 358 U.S. 450, 457-458 (1959); *see also Wardair Canada 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").

[6] These locational distortions (when involving capital) are referred to as violations of capital export neutrality, or CEN.

[7] These distortions (when involving capital) are referred to as violations of capital import neutrality, or CIN.

[8] *See* Ruth Mason and Michael S. Knoll, "What Is Tax Discrimination?" 121 *Yale L.J.* 1014, 1060-1074 (2012); Mason and Knoll, "Waiting for Perseus," 67 *Tax L. Rev.* 375, 436-441 (2014). These

(Footnote continued on next page.)

advantage over nonresidents when both compete to earn income in the state, and (2) a state cannot discourage residents from earning out-of-state income rather than in-state income. While we cannot hope to make a conclusive case for competitive neutrality in this article, support for the claim can be found in prominent cases.[9]

B. What Competitive Neutrality Means for State Taxation

Each state can tax three kinds of income:

- domestic income — in-state income earned by residents;
- outbound income — out-of-state income earned by residents; and
- inbound income — in-state income earned by nonresidents.

States generally lack jurisdiction under the due process clause to tax the income that nonresidents earn in other states. This section uses economics to describe what we mean when we construe the Court's dormant commerce clause doctrine to require competitive neutrality or a level playing field.

We present the economic analysis using a two-state example involving Maryland and Delaware, in which Delaware stands in for all states other than Maryland. The share of income that a taxpayer retains after paying tax is called a retention rate. Table 1 provides, for each kind of income taxable by Maryland, retention rates for Maryland and non-Maryland (proxied by Delaware) taxpayers after paying Maryland tax. To keep the example simple, we assume that Delaware does not impose any tax. So the retention rates in Table 1 represent the share of earnings retained after Maryland tax.

Table 1.
Retention Rates on Income Taxable by Maryland

	Maryland Resident	Delaware Resident
Activity in Delaware	Outbound Income $1 - T_o$	1
Activity in Maryland	Domestic Income $1 - T_d$	Inbound Income $1 - T_i$

The retention rate for a Maryland resident on an investment in Maryland is $1 - T_d$, where T_d is Maryland's tax on its residents' in-state income (that is, Maryland's domestic tax). Likewise, the retention rate for a Maryland resident on an investment in Delaware is $1 - T_o$, where T_o is Maryland's tax on residents' out-of-state income (that is, Maryland's outbound tax).

The retention rate for a Delaware resident on an investment in Maryland is $1 - T_i$, where T_i is Maryland's tax on nonresidents' Maryland-source income (that is, Maryland's inbound tax). Because Maryland does not tax nonresidents' out-of-state income, a Delaware resident's after-Maryland-tax retention rate on an investment in Maryland equals 1.

Because investors allocate capital across investments in different taxing jurisdictions based on relative retention ratios (that is, comparisons of retention ratios),[10] we need to calculate the retention ratios of Maryland and Delaware residents on investments in Maryland and Delaware. A Maryland resident's retention ratio is the share of income remaining when she invests in Maryland relative to what remains when she invests outside Maryland (in Delaware). Thus, a Maryland resident's retention ratio on an investment (in Maryland relative to an investment in Delaware) is $(1 - T_d)/(1 - T_o)$. Similarly, a Delaware resident's retention

distortions (when involving capital) are commonly referred to as capital ownership neutrality, or CON.

[9]For example, in *West Lynn Creamery*, the Supreme Court used the dormant commerce clause to strike down a tax that applied to both resident and nonresident milk dealers because it was linked to a preferential subsidy for resident milk producers. In the Court's view, the combination of the tax and preferential subsidy "neutraliz[ed] the advantage possessed by lower cost out-of-state producers." *West Lynn Creamery Inc. v. Healy*, 512 U.S. 186, 194 (1994). This analysis expressly shows a concern that state taxes should not undermine nonresidents' comparative advantage over residents. *See also West Lynn Creamery Inc.* at 193 (noting that the Constitution forbids tariffs because they "artificially encourage in-state production even when the same goods could be produced at a lower cost in other states").

[10]Our approach is rooted in the theory of finance, particularly in the theory of portfolio allocation in the presence of taxes. In an environment without taxes, the major result of capital asset pricing models (CAPMs) is that all investors end up holding the full universe of available risky assets in the same proportion as those assets are available in the market. Investors might vary the amount of riskless debt and risky assets they hold, and, of course, the total amount invested in risky assets will differ depending on the size of one's investment portfolio and attitude toward risk, but everyone will hold the same portfolio of risky assets, differing only in the size of the portfolio, but not in the relative portion of the portfolio (of risky assets) invested in each asset. The risky portfolio of assets held by each taxpayer is called the market portfolio because it is composed of a pro rata portion of all available (risky) assets. The after-tax capital asset pricing model (after-tax CAPM) describes how taxes affect how investors allocate their investment capital across assets in an environment with differentially taxed assets and taxpayers. The main insight from the after-tax CAPM is that an investor's demand for an asset is determined not by a simple comparison of how an investor is taxed on that asset relative to how other investors are taxed on that same asset. Instead, an investor's demand for an asset is determined by how she is taxed on that asset relative to how she is taxed on the market portfolio as compared with how other investors are taxed on that asset relative to how they are taxed on the market portfolio. The central result is that an investor will invest more in an asset when she is taxed lightly relative to how she is taxed on the market portfolio as compared with how other investors are taxed on the asset relative to how they are taxed on the market portfolio. The converse also holds: An investor will invest less in an asset on which she is taxed more heavily relative to the market portfolio than are other investors. *See* Michael Brennan, "Taxes, Market Valuation and Corporate Financial Policy," 23 *Nat'l Tax J.* 417 (1970); Roger H. Gordon and David F. Bradford, "Taxation and the Stock Market Valuation of Capital Gains and Dividends," 14 *J. Pub. Econ.* 109 (1980).

ratio on an investment (in Maryland relative to an investment in Delaware) is the share of income she retains when she invests in Maryland relative to what she retains when she invests in Delaware. Thus, a Delaware resident's retention ratio on an investment in Maryland is $(1 - T_i)/1$, or $1 - T_i$.

In order for Maryland taxes not to discriminate against interstate commerce, the retention ratio for residents of Maryland across Maryland and Delaware must be less than or equal to the retention ratio for residents of Delaware across Maryland and Delaware.[11] This requirement can be written as:

$$(1 - T_d)/(1 - T_o) \leq (1 - T_i)/1 \qquad (1)$$

Equation 1 describes the situation in which income taxes do not distort interstate competition in terms of retention rates, which are the share of pretax income taxpayers retain after paying Maryland tax. This shows how tax, through individual investment choice, affects interstate competition. When, as in *Wynne*, the constitutional challenge is to a state's tax rates, and not to its base, the above logic reduces to a straightforward mathematical guideline for avoiding distorting interstate competition:

$$T_d \geq T_o + T_i - (T_o \times T_i) \qquad (2)$$

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.[12] If a state's tax rates do not satisfy Equation 2, its tax system discriminates against interstate commerce.[13] Notice that this equation does not specify any of the rates; rather it specifies the relationship that the rates must maintain with respect to each other. A state may set its tax rates as high or as low as it wants. The dormant commerce clause, however, prevents a state from setting its tax on domestic income independently from its tax on interstate (inbound and outbound) income.

Courts interpreting the dormant commerce clause need not engage in the kind of economic analysis we presented here (let alone the more extensive analysis of our earlier articles). Instead, the principle that underlies the dormant commerce clause — that states should not distort competition between their residents and residents of other states — generates simple rules of thumb. One rule, represented by Equation 1, is that a state must set tax rates so that retention ratios for residents and nonresidents are equal across jurisdictions. A second rule, represented by Equation 2, is that the tax rate on residents' in-state income must equal the combined tax rate on the in-state income of nonresidents and on the out-of-state income of residents.[14] In other words, the tax rate on domestic income must be equal to or greater than the tax rate on interstate income, composed of inbound and outbound economic activities.

In earlier work, we described a third rule — that state taxes must be uniform.[15] A source tax is uniform if it applies at the same rate and on the same base[16] 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. And 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.

Still another rule of thumb is one the Supreme Court introduced in 1983 and currently uses in state tax discrimination cases, namely, the internal consistency test.[17] The next section describes that test and shows the equivalence of the test to the economic analysis just presented.

C. Competitive Neutrality in the Court's Doctrine: The Internal Consistency Test

In 1977, in *Complete Auto Transit, Inc. v. Brady*,[18] the Court adopted the modern four-part test for evaluating state taxes under the dormant commerce clause. A state tax does not violate the commerce clause if it (i) applies to an activity with substantial nexus to the taxing state; (ii) is fairly apportioned; (iii) does not discriminate against out-of-state parties; and (iv) fairly relates to services provided by the taxing state. In most dormant commerce clause cases, including *Wynne*, the first and fourth prongs are not at issue. Instead, dormant commerce clause disputes involve the middle two prongs, both of which relate to the ideal of a level playing field between in-state and out-of-state parties.

In many dormant commerce clause cases since 1983, the Supreme Court has used the internal consistency test to

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[11]How taxation affects competition between residents of different states depends upon relative retention ratios. If the parties' ratios are the same (even though their tax rates are different), taxation will not affect where either party invests. If, however, their ratios are different, taxation will distort competition. Mason and Knoll, "What Is Tax Discrimination?" *supra* note 8.

[12]Expressed differently, the tax rate Maryland applies to its residents' Maryland-source income must be the same as if Maryland first applied the rate applicable to residents' out-of-state income and then applied to the remaining income the rate applicable to nonresidents' Maryland-source income.

[13]Mason and Knoll, "Waiting for Perseus," *supra* note 8 (providing an algebraic derivation of non-distortion conditions).

[14]The first two rules (retention ratios and tax rates) apply when the only issue in dispute is tax rates, not tax bases. The uniformity rule and the internal consistency test apply to cases involving base or rate challenges, or both. All four rules require adjustment when the residence state provides a credit for foreign taxes. *See, e.g.*, Mason and Knoll, "Waiting for Perseus," *supra* note 8, at 1074.

[15]*Id.* (describing uniformity requirements for taxes not to distort competition).

[16]Tax base refers to the rules for calculating taxable income.

[17]*Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

[18]430 U.S. 274 (1977).

evaluate the fair apportionment and nondiscrimination prongs of the *Complete Auto* test.[19] Under the Court's doctrine:

> internal 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.[20]

The internal consistency test directs the reviewing court to assume every state enacts the challenged tax regime, and then it asks whether, under such hypothetical harmonization, interstate commerce suffers a greater burden than does in-state commerce. Note the close correspondence between the internal consistency test, Equation 2, and the requirement that all taxes be uniform.[21] For a tax system that does not provide credits for taxes paid on out-of-state income, the three statements are equivalent and yield the same result.[22] The internal consistency test works because it reaches the same results by logic and intuition that economic analysis reaches by algebra.

III. Economic Analysis of *Wynne*

A. Factual and Legal Background

The respondents, Brian and Karen Wynne, married Maryland residents, own stock in Maxim Healthcare Services Inc., a Maryland S corporation that provides healthcare and medical staffing throughout the United States. Maryland follows federal tax law in treating S corporations as passthrough entities. In tax year 2006, the Wynnes earned more than $2.6 million in income, much of it from Maxim, which filed tax returns in 39 states.[23]

Maryland formally divides its individual income tax into a state portion with a maximum rate of 4.75 percent, and a county portion with rates ranging from 1.25 to 3.2 percent.[24] Maryland collects both portions of the tax, but it remits the county portion to the counties. Although Maryland formally labels part of its tax as a county tax and part as a state tax, it is settled law that Maryland's county tax constitutes a state tax for constitutional law purposes, and no party contests that issue in *Wynne*.[25]

Maryland allows taxes paid to other states to fully offset the portion of its tax that Maryland labels the state tax, but it disallows any credit against the county tax.[26] Thus, although the Wynnes received credit for taxes paid to other states against the Maryland state tax, they received no credit against their Maryland county tax. The substance of the dispute in *Wynne* concerns only the county tax.

Ignoring the uncontested state portion of the tax, the Maryland tax regime contains the following elements.

For residents:

- on income earned in Maryland, county tax of 1.25 percent to 3.2 percent, depending on the county of residence (we call this the domestic tax);[27] and
- on income earned in other states, county tax of 1.25 percent to 3.2 percent, depending on the county of residence, against which there is no credit for other states' taxes (we call this the outbound tax).[28]

For nonresidents:

- on income earned in Maryland, a 1.25 percent county tax (Maryland calls this the special nonresident tax, or SNRT; we call it the inbound tax);[29] and
- on income earned in other states, no tax.

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[19]*See, e.g.*, *Armco Inc. v. Hardesty*, 467 U.S. 638 (1984) (applying internal consistency test in a discrimination case).

[20]*Jefferson Lines Inc.*, 514 U.S. at 185.

[21]In both substance and form, the internal consistency test is equivalent to the tax rate rule as described in Equation 2. The left side of Equation 2, the tax rate on domestic residents' domestic income, is the same value as in the unshaded (i.e., in-state income) quadrants of Table 3. The right side of Equation 2, the total tax rate from applying the state's taxes on inbound and outbound commerce, is the same as the values in the shaded (i.e., interstate income) quadrants of Table 3. Because the internal consistency test asks whether the tax rates in all four quadrants are equal, it is essentially asking whether Equation 2 holds. The internal consistency test is also equivalent to the rule that retention ratios should be equal across residents of different states because that rule, which was mathematically expressed in Equation 1, was the source from which Equation 2 was derived. Finally, internal consistency is also equivalent to the uniformity requirement: Nonuniform tax laws fail the internal consistency test because a system with nonuniform laws violates Equation 2.

[22]Because Maryland does not grant credits against its county tax, we can use the simplified formula in evaluating *Wynne*. The calculations become more complicated in cases in which residence states provide credits for source taxes. *See* Mason and Knoll, "What Is Tax Discrimination?" *supra* note 8, at 1063-1064, 1072-1074.

[23]Petitioner's brief, at 5-6.

[24]Md. Code Ann., Tax-General (Md. T.G.) sections 10-102, 10-103(a)(1).

[25]*See, e.g., Nippert v. City of Richmond*, 327 U.S. 416 (1946) (striking down a municipal license tax on business solicitors for violating the dormant commerce clause); *see also Frey v. Comptroller of Treasury*, 29 A.3d 475, 492 (Md. 2011) (concluding that Maryland's county income taxes were state taxes for constitutional law purposes).

[26]Md. T.G. section 10-703(a).

[27]Md. T.G. section 10-103(a)(1).

[28]Md. T.G. sections 10-103(a)(1), 10-703.

[29]Md. T.G. section 10-106.1(a). Just as it taxes residents, Maryland subjects nonresidents with Maryland-source income to the 4.75 percent state portion of the Maryland individual income tax, but we ignore the state portion of the tax for purposes of this analysis. *See* Md. T.G. section 10-105(d). In lieu of the SNRT, Maryland subjects nonresidents who receive compensation for employment in Maryland to the county tax rates ranging from 1.25 to 3.2 percent. *See* Md. T.G. section 10-103(a)(4). Nonresidents with Maryland income from sources other than employment pay the SNRT, which Maryland sets equal to the lowest county tax rate, 1.25 percent.

The Wynnes resided in Howard County, where the county tax rate was 3.2 percent, so the Wynnes paid county tax of 3.2 percent on their domestic and outbound income.[30] Table 2 illustrates the Maryland county tax regime for Howard County:

Table 2.
Maryland County Tax Regime

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

B. Maryland's Tax Regime Is Internally Inconsistent

Recall that the internal consistency test directs a court to assume every state enacts the same tax regime, and then asks whether, under such hypothetical harmonization, interstate commerce suffers a greater burden than does in-state commerce. Table 3 shows how income would be taxed if every other state (represented here by Delaware) adopted the Maryland Howard County tax:

Table 3.
Maryland Tax Under the Internal Consistency Test

	Maryland Resident	Delaware Resident
Activity in Delaware	4.45%[a]	3.2%
Activity in Maryland	3.2%	4.45%

[a]Delaware, employing a tax regime identical to Maryland's, would impose a special nonresident tax of 1.25 percent on taxpayers such as the Wynnes, who reside in Maryland but earn income in Delaware. Maryland would neither credit the Delaware SNRT against its own 3.2 percent residence-based county tax nor allow a deduction for the SNRT paid to Maryland. The Delaware source-based SNRT tax (or county tax) plus the Maryland residence-based county tax yields a total source-and-residence tax rate of 4.45 percent.

Table 3 shows that the Maryland county tax is internally inconsistent because under hypothetical harmonization, in-state income would be taxed at 3.2 percent, whereas interstate income would be taxed at 4.45 percent. The shaded quadrants in Table 3 represent interstate income, comprising Maryland income earned by Delaware residents and Delaware income earned by Maryland residents. In contrast, the unshaded quadrants represent in-state income, comprising Maryland income earned by Maryland residents and Delaware income earned by Delaware residents. Accordingly, the Maryland Court of Appeals concluded that the Maryland tax regime violates the internal consistency test.[31]

The court of appeals left it to the Maryland General Assembly to choose how to remedy the violation.[32] The court clarified that its holding did not require Maryland to use a credit to cure its constitutional violation.[33] By this clarification, the Maryland Court of Appeals expressly acknowledged that there are multiple ways that Maryland could revise its tax system so as to pass constitutional muster.[34]

As the discussion above suggests, the decision of the Maryland Court of Appeals was a straightforward application of existing legal doctrine, particularly the internal consistency test. Thus, *Wynne* seems like an easy case, and it lacks the usual indicia for granting certiorari, such as a conflict between circuits.[35] That raises the question of why the U.S. Supreme Court took the case. To help answer this question, we turn to the arguments made by the parties and amici in *Wynne*.

C. Maryland's Defenses

Among other defenses, Maryland argues that its tax regime does not discriminate. It also argues that Maryland's need for money and the duty of its residents, including the Wynnes, who consume services in Maryland trump constitutional concerns. Finally, Maryland argues that the excessive taxes the Wynnes pay are not solely the fault of Maryland; rather, they arise because of the interaction of Maryland's tax system with those of other states, and therefore Maryland cannot be held accountable for any adverse impact.

1. No Discrimination

Maryland argues that its tax does not violate the dormant commerce clause because it does not discriminate. All discrimination standards involve comparisons, and the most

[30]The Wynnes also paid the state portion of the Maryland tax, and against that portion received credits for taxes paid to other states.

[31]*Comptroller of the Treasury v. Wynne*, 64 A.3d 453, 466 (2013) (concluding that "the circumstances under which the courts have tolerated a lack of internal consistency [such as flat usage fees] do not pertain here"). *See also Wynne* at 470 (concluding that the Maryland regime violated the dormant commerce clause by failing to credit other states' taxes). Maryland fails the internal consistency test regardless of the county analyzed. If, for example, we apply the internal consistency test to the lowest Maryland county tax rate of 1.25 percent, then in-state income is always taxed at 1.25 percent, whereas interstate income is always taxed at 2.5 percent. Maryland's county tax rate on cross-border income is always 1.25 percent higher than the county tax rate on domestic income.

[32]*See Wynne*, 64 A.3d at 478.

[33]Petitioner's cert. brief, appendix B, opinion on motion for reconsideration, p. 51 ("A state may avoid discrimination against interstate commerce by providing a tax credit, or some other method of apportionment, to avoid discriminating against interstate commerce in violation of the dormant commerce clause").

[34]*See id.*

[35]Greve, *supra* note 3, at 270.

contentious part of tax discrimination cases can be determining how to properly make the comparisons. In *Wynne*, Maryland urges the Court to compare Maryland's treatment of its own residents' Maryland-source income with its treatment of their out-of-state income. As long as the domestic rate is no lower than the outbound rate (that is, $T_d \geq T_o$), under Maryland's view, the tax is not discriminatory. Because Maryland applies the same rate to its residents' domestic and outbound income, according to the comptroller, the Maryland tax is constitutional.[36]

However, in *Comptroller v. Frey*,[37] an earlier case challenging application of Maryland's inbound tax regime to nonresidents, the comptroller offered a different comparison. In that case, the comptroller convinced the Maryland Court of Appeals that it should compare Maryland's treatment of residents' Maryland-source income with Maryland's treatment of nonresidents' Maryland-source income. In other words, the court should compare Maryland's domestic tax with its inbound tax, and as long as the domestic tax was at least as high as the inbound tax (that is, $T_d \geq T_i$), Maryland did not discriminate, according to the comptroller. Because, under that limited comparison, Maryland treated nonresidents more favorably than residents, the court of appeals concluded in *Frey* that Maryland did not violate the dormant commerce clause.[38]

Thus, in *Frey*, the comptroller persuaded the Maryland court to consider whether Maryland discriminated against only inbound commerce. Now, just five years later in *Wynne*, the comptroller asks the Supreme Court to evaluate the question whether Maryland discriminates against only outbound commerce. Combining these arguments, we arrive at Maryland's understanding of the limits the dormant commerce clause places on state taxation, namely that:

$$T_d \geq T_o \text{ and } T_d \geq T_i \qquad (3)$$

Under the comptroller's theory, a state's outbound and inbound taxes have no necessary relationship to each other, and so long as each is less than or equal to the domestic tax, the comptroller would argue that there is no constitutional violation. This is even though Maryland's inbound and outbound taxes impose a cumulative burden on interstate commerce that exceeds by Maryland's single imposition of tax on domestic income.

Combining *Frey* with *Wynne* illustrates the problem. In *Frey*, the comptroller compared Maryland's inbound tax with its domestic tax;[39] in *Wynne*, the comptroller compares Maryland's outbound tax with its domestic tax. Double-counting the domestic tax obscures that although Maryland taxes residents' domestic income once, it taxes interstate commerce both coming and going.[40] The combined Maryland taxes on interstate commerce (that is, the inbound tax plus the outbound tax) total 4.45 percent, thus exceeding the Maryland tax on residents' domestic income of 3.2 percent. If all states adopted similar regimes, interstate commerce would always face more tax than domestic commerce. As the economic analysis above shows, determining whether a state discriminates against interstate income requires comparing the state's domestic tax with its total burden on interstate commerce, composed of its inbound and outbound taxes.[41]

Because the internal consistency test prevents disaggregation of the state tax regime into inbound-only and outbound-only elements, it prevents the kind of incomplete analysis urged by the comptroller in both *Wynne* and *Frey*. It therefore reduces the risk that states will eviscerate the clause's protection for interstate commerce by embedding discriminatory tax provisions in disparate parts of their tax regimes.

At oral argument, Eric J. Feigin, the assistant U.S. solicitor general, argued that the Wynnes should not be able to point to the inbound tax (the SNRT) as part of their discrimination analysis because, as residents, they were not subject to it. He added that the nonresident tax "is going to look discriminatory no matter what other scheme of taxes you throw into it."[42] He argued that if the Court found the Maryland tax regime discriminatory, "it would probably be much more logical to locate the problem in the nonresident tax rather than the resident tax."[43] When pressed by Justice Samuel Alito about whether he thought the nonresident tax was unconstitutional, Feigin replied that he did not but only that "it would be a stronger claim."[44]

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[36]Petitioner's brief at 35-36. The assistant to the U.S. solicitor general also urges comparing the domestic tax only with the outbound tax, describing the taxes as "uniform" and "even-handed." *Wynne*, argument transcript, at 23.

[37]29 A.3d. 475 (Md. 2011), *cert. denied*, 132 S. Ct. 1796 (2012).

[38]*See Frey*, 29 A.3d at 501.

[39]*Frey*, 29 A.3d at 496, 505.

[40]To avoid discouraging interstate commerce, Maryland could, for example, impose both taxes — the residence tax and the source tax — on residents' Maryland income. In that case, Maryland would have uniform taxes — a uniform source tax of 1.25 percent and a uniform residence tax of 3.2 percent. But there are other alternatives for Maryland to cure its violation, as we discuss in Part IV.D.

[41]The comptroller's analysis is wrong, because it obscures the fact that the Maryland tax system disadvantages nonresidents compared with residents. This disadvantage is evident because the retention ratio for Maryland residents on their income earned in Maryland relative to their income earned outside Maryland is higher than the same ratio for nonresidents. In a recent working paper, economists Ryan Lirette and Alan Viard reached the same conclusion about the need to compare the state's tax on domestic income with the cumulative burden the state applies to inbound and outbound income. *See* Lirette and Viard, "State Taxation of Interstate Commerce and Income Flows: The Economics of Neutrality," American Enterprise Institute working paper 2014-07 (Sept. 23, 2014).

[42]*Wynne*, argument transcript, at 18.

[43]*Id.* at 20-1.

[44]*Id.* at 23.

We disagree. While we conclude that the Maryland regime, taken as a whole, discriminates against interstate commerce, we do not believe that it is possible as a matter of logic or economics to isolate the source of the discrimination to any one of the domestic tax, the inbound tax, or the outbound tax. All three tax rates must be analyzed together, and they must obey the relationship in Equation 2. Thus, it should not be possible to save Maryland's tax regime by arguing that it is the inbound tax (rather than the outbound tax) that discriminates.

2. Revenue Argument

Maryland and amici make much of Maryland's need for tax revenue and of the benefits that the Wynnes receive from Maryland. Maryland and amici further claim that holding for the Wynnes would allow the Wynnes and others similarly situated to avoid paying for their share of the services they consume.

It is important to note that 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. The Wynnes could pay more tax under a properly designed credit than they would pay on an equivalent amount of domestic income, but they would not pay less.

Of course, Maryland's concern is that if it credited other states' taxes, the taxes paid by the Wynnes on their out-of-state income would go principally to the source state, and only residually to Maryland. In its brief, Maryland noted that the Wynnes (or similar taxpayers) might end up owing zero income tax to Maryland on their out-of-state income, and at oral argument, some of the justices raised similar concerns.[45] Justice Ruth Bader Ginsburg gave an example in which granting a credit would mean that "the Maryland resident owes nothing to Maryland . . . [even though he] may have five children that he sends to school in Maryland."[46] Continuing Ginsburg's example, Justice Anthony Kennedy commented, "He's getting a free ride off Maryland school."[47] Because the Wynnes receive significant benefits from Maryland, it is only fair, the argument goes, that the Wynnes contribute to fund those benefits, consistent with their ability to pay.

One response is to note that Maryland taxes not only on a residence basis, but also on a source basis. What Maryland loses on a residence basis, it gains on a source basis. Notice the symmetry: The Wynnes pay taxes to other jurisdictions while receiving only limited services there (they do not, for example, send their children to other states' public schools). At the same time, Maryland collects revenue from nonresidents who earn income in Maryland, despite using only limited Maryland services. Thus, Maryland will only lose revenue on an aggregate basis from interstate commerce if Maryland residents earn more abroad than the residents of other states earn in Maryland. Thus, Maryland exaggerates the revenue loss from maintaining an internally consistent tax regime. It is telling that every other state besides Maryland (not to mention independent countries) appears able to fund its public sector despite granting credits for out-of-state taxes.

Moreover, that a state provides services to residents cannot justify taxes that impede access for its residents to out-of-state markets and vice versa. The Maryland tax regime challenged in *Wynne* does both.[48] And upholding the Maryland county tax regime just because Maryland uses the revenue to pay for services would eviscerate the dormant commerce clause.

There are other ways that Maryland could tax the Wynnes to pay for services that would not discriminate against cross-border commerce and that would be internally consistent. For example, Maryland could impose a real property tax, a head tax, or charge a fee to those who send their children to the public schools. Finally, Maryland could modify its income tax regime to comply with the dormant commerce clause, while still refusing to credit other states' taxes.[49]

3. Who Can Say Which State Is at Fault?

Maryland argues that the higher tax burden the Wynnes face on cross-border income "arises from the combination of the income taxes of two States,"[50] so therefore Maryland is not responsible for it. This argument seemed to resonate with Justice Stephen Breyer, who said at oral argument, "I don't see anybody at fault."[51]

What this argument ignores is that the Maryland tax system would discourage interstate commerce even if no other state imposed any taxes. If no other state imposed any taxes, Maryland residents and nonresidents would pay the same 3.2 percent tax on in-state and out-of-state income and Maryland residents would retain 96.8 percent of their before-tax earnings on both in-state and out-of-state income. Thus, the ratio of what Maryland residents retain on Maryland income as opposed to non-Maryland income is 1. Nonresidents pay 1.25 percent tax on their Maryland income and so retain 98.75 percent of their Maryland income, whereas they retain 100 percent of their non-Maryland income, which is not subject to tax. Thus, nonresidents retain 98.75 percent as much of their income when they earn that income in Maryland as when they earn it outside Maryland. Accordingly, although nonresidents retain a higher portion of their income than do Maryland residents wherever they earn income,[52] nonresidents retain a relatively smaller ratio of their income when they invest in

[45]*Id.* at 29.
[46]*Id.*
[47]*Id.* at 39.

[48]*See supra* Part II.D.
[49]*See infra* Part IV.D.
[50]*Wynne*, argument transcript, at 22.
[51]*Id.* at 23.
[52]When they invest outside Maryland, nonresidents retain 100 percent of pretax income whereas Maryland residents retain only 96.8

(Footnote continued on next page.)

Maryland as compared with investing outside Maryland (0.9875) than do residents (1). The inequality in those retention ratios shows the distortion of competitive neutrality and thereby the tax discrimination.

IV. Distinguishing Double Taxation From Discriminatory Taxation

Other disputes in *Wynne* involve whether the dormant commerce clause forbids double taxation, and if so, whether the source state or the residence state is obliged to relieve the double tax. Likewise, there is a dispute over whether the only appropriate remedy in the case is a tax credit. Justice Elena Kagan also raised the concern that a ruling in favor of the Wynnes paradoxically could lead to more double taxation. This section addresses those arguments.

A. The Dormant Commerce Clause Precludes Some, But Not All, Forms of Double Tax

Double tax is neither a necessary nor sufficient condition for a dormant commerce clause violation. It is obvious that a state can discriminate against cross-border commerce without imposing double taxation. Assume, for example, that Maryland is the only state to tax, and assume further that Maryland stops taxing its residents' out-of-state income, maintains its 3.2 percent tax rate on residents' domestic income, and increases the SNRT rate on nonresidents' Maryland income to 5 percent. Although there is no double taxation, such a tax discriminates against cross-border commerce. Nonresidents would face a tax disadvantage in Maryland relative to residents because nonresidents would retain a smaller portion of their revenue earned in Maryland (as compared with the portion they would retain on revenue earned in Delaware) than residents.[53]

Conversely, there can be double taxation without discriminating against cross-border commerce. If Maryland combines a uniform 3.2 percent residence tax with a uniform 1.25 percent source tax and applies both taxes to its residents' domestic income (4.41 percent), there is double taxation, but no discrimination against cross-border commerce. Also, if Delaware (standing in for all other states) adopts a uniform 5 percent residence tax and a uniform 4 percent source tax and applies both taxes to Delaware residents' domestic income (8.8 percent), there is double taxation, but again no discrimination. That is because Maryland residents retain the same portion of their income earned in Maryland relative to the proportion retained by Delaware residents on their Delaware income. There is also no discrimination from combining both the Maryland and Delaware tax systems, even though all cross-border income is taxed by both Delaware and Maryland.[54] Once again, there is no competitive distortion because the retention ratios across Maryland and Delaware for Maryland and Delaware residents are equal.

There is, however, an important case in which avoiding discrimination requires relief from double taxation. When a state taxes residents and nonresidents at the same rate on their in-state income, the only way the state can avoid discouraging cross-border commerce (and satisfy the internal consistency test) is to exempt out-of-state income from tax or provide a credit for taxes paid on out-of-state income. Those tax systems are common, which is why one might view the dormant commerce clause as prohibiting double tax.

By arguing that the dormant commerce clause forbids double taxation, the taxpayer raised unnecessary controversy. At issue in *Wynne* is not whether the Constitution forbids double tax, but rather whether it forbids a state from using taxes to give residents a competitive advantage over nonresidents for jobs and investments in the state and whether it forbids a state from using taxes to give nonresidents a competitive advantage over residents for jobs and investments outside the state. By its internal inconsistency, the Maryland tax regime does both: It privileges Marylanders over nonresidents when earning income in Maryland, and it privileges nonresidents over Marylanders when earning income outside Maryland.

A constitutional rule that says that a state's tax law must be internally consistent is administrable by any state and requires examination only of that state's tax regime. In contrast, a generalized prohibition on double taxation is less administrable because it requires determining when there has been double taxation, which in turn depends on careful comparison of the two states' tax bases and source rules.[55] A constitutional prohibition on double taxation would raise other difficult questions, such as the constitutionality of partial credits, the equivalence of credits and exemption, and whether the source or residence state has priority to tax, a question we address in the next section. Finally, it is worth noting that Supreme Court doctrine does not support interpreting the dormant commerce clause as a blanket prohibition on double taxation.[56]

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percent; when they invest in Maryland, nonresidents retain 98.75 percent while residents retain 96.8 percent.

[53]Nonresidents retain 95 percent as much of their income when they earn income in Maryland rather than Delaware, while residents retain 96.8 percent as much.

[54]*See* Mason and Knoll, "Waiting for Perseus," *supra* note 8, at 442-452 (providing an extensive example showing that uniform double taxes do not distort cross-border commerce).

[55]The Supreme Court in *Moorman* declined to find that the dormant commerce clause forbade double taxation in part because applying such a rule "would require extensive judicial lawmaking."

[56]*Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 98 S. Ct. 2340 (1978) (approving internally consistent apportionment formula, even though its application in combination with another state's different, but also internally consistent, formula resulted in actual double taxation).

B. The Dormant Commerce Clause Does Not Require The Residence State to Yield to the Source State

Traditionally, the Supreme Court has looked exclusively to the law of the challenged state in analyzing state tax dormant commerce clause challenges. The court has said that the constitutionality of one state's law cannot "depend on the shifting complexities of the tax codes of 49 other States."[57] However, the Wynnes, like the comptroller, expand the inquiry to at least two states by arguing that the Constitution requires Maryland to relieve double taxation. But if the Constitution requires relief of double tax, which state's tax must give way? Questions at oral argument suggest that the justices see a holding for *Wynne* as raising a "priority rule" question. For example, Justice Antonin Scalia asked, "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?"[58] In our view, the dormant commerce clause does not mandate (and need not be interpreted as mandating) any priority between the source and residence states' taxes.

When asked whether the dormant commerce clause encompasses a priority rule, Dominic F. Parella, the Wynnes' lawyer, argued that the Court's doctrine establishes a source-state priority rule, under which the residence state must yield to the source state's tax, for example, by granting a credit. He cited *Standard Oil*,[59] *Mobil Oil*,[60] and *Central Railroad*[61] in support of this assertion. Support for a source-state priority rule can indeed be found in those cases, particularly for ad valorem taxation of instrumentalities of interstate commerce.[62] If extended to personal income taxes, a source-state priority rule would reflect the usual state practice of granting credits at residence, as well as the international practice of crediting or exempting at residence. Nevertheless, dormant commerce clause doctrine provides no clear guidance on which state should relieve double taxation.[63]

While the Court's precedent more strongly supports the notion of source (rather than residence) priority-to-tax, there is no need for the Court to establish a priority rule under the dormant commerce clause in order to resolve the case in favor of the Wynnes. Rather, all the Court need require is that states exercise taxing authority on legitimate bases (source and residence) and that all taxes be uniform on a source or residence basis. In other words, all taxes must be internally consistent.

Although it is a minority practice, some source states unilaterally cede priority to tax to the residence state,[64] or they do so under reciprocal source-exemption provisions.[65] Thus, in our view, the Court should answer the priority rule question in *Wynne* as it did in Moorman, by stating that:

> the legislative power granted to Congress by the commerce clause would amply justify the enactment of legislation requiring all states to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed those policy decisions.[66]

C. A Credit Is Not the Only Possible Remedy

If the Wynnes prevail, a question arises as to the appropriate remedy. Several amici who support the taxpayers urge the Court, assuming it finds the Maryland tax unconstitutional, to order Maryland to credit other states' taxes to offset the Maryland county tax. However, because there are several other ways for Maryland to cure its constitutional infirmity, the Supreme Court should not order Maryland to issue credits.

To comply with the dormant commerce clause, Maryland's tax rates must obey Equation 2; they must bear the following relationship to each other:

$$T_d \geq T_o + T_i - (T_o \times T_i) \qquad (2)$$

Under this constraint, Maryland has flexibility to set any two rates however it chooses, but setting the first two rates constrains the third. For example, suppose Maryland determines that it wants an inbound income tax rate, T_i, of 1.25 percent. Suppose further that Maryland wants an outbound

[57]When analyzing state tax discrimination under the commerce clause, the U.S. Supreme Court declined to require a taxpayer to show actual discriminatory impact by pointing to a duplicative tax in another U.S. state. *ARMCO Inc. v. Hardesty*, 467 U.S. 638, 644 (1984).

[58]*See, e.g., Wynne*, argument transcript, at 9-10. *See also id.* at 10, "Do you stop having the power to tax worldwide income because other States may tax on a different [source] basis?" (Ginsburg, J.).

[59]*Standard Oil Co. v. Peck*, 342 U.S. 382, 384 (1952) (invalidating a residence-based ad valorem tax on ships used in interstate commerce on the grounds that the "rule which permits taxation by two or more [source] states on an apportionment basis precludes taxation of all of the property by the state of the domicile").

[60]*Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425 (1980) (holding that a state could tax a nonresident corporation's foreign-source dividends by apportionment).

[61]*Central R. of Pa. v. Pa.*, 370 U.S. 607, 614 (1962) ("the domiciliary State is precluded from imposing an ad valorem tax on any property to the extent that it could be taxed by another State").

[62]Each of the cited cases involved apportionment formulas, so rather than establishing a source priority rule, these cases instead could be understood to require fair apportionment. If income "fairly apportioned to a state" is understood to be equivalent to "income sourced in a state," the two notions collapse into one. In international tax policy, apportionment is regarded as an alternative to sourcing rules, but with the same goal, namely, to allocate taxing rights among states with legitimate tax claims while at the same time avoiding double taxation.

[63]Indeed, the leading treatise on state taxation concludes that "the question arises as to whether, and under what circumstances, the Constitution may be read to require a taxpayer's state of residence . . . to provide a credit for taxes paid to other states. This is a complicated question for which the courts have yet to provide a definitive answer." Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, at para. 20.10[2][b].

[64]*Id.* at para. 20.10.

[65]*Id.* at para. 20.10[6].

[66]*See Moorman*, 437 U.S. at 280.

tax rate, T_o, of 3.2 percent with no credit. Maryland can implement both of these tax rates consistently with the dormant commerce clause. The step that Maryland missed in constructing its tax regime was that the tax rate on the third basis is algebraically constrained by the first two rates. Under those conditions, to avoid discriminating against interstate commerce, Maryland's tax rate on domestic income, T_d, must be no less than the sum of the taxes on the other two bases, less their product, or 4.41 percent.

Although crediting other states' taxes generally will cure a tax's internal inconsistency,[67] the Constitution gives no answer to the question whether Maryland should, for example (1) increase domestic tax, T_d, to 4.41 percent,[68] (2) reduce the outbound tax, T_o, either by eliminating that tax or by allowing a full credit against it, or (3) eliminate the 1.25 percent inbound tax, T_i. The choice of how to satisfy Equation 2 remains the sovereign choice of Maryland.

D. A Ruling in Favor of the Taxpayers Could Lead to More Double State Taxation

At oral argument, Kagan raised the concern that using internal consistency as the principal test for tax discrimination could result in a situation in which some states choose to tax exclusively on a source basis, while others choose to tax exclusively on a residence basis. Each state's regime considered separately would satisfy the internal consistency test, but a taxpayer who resides in one, but earns income from the other could face double tax or no tax.[69] Kagan is correct inasmuch as different choices by different states can affect how many times and at what total rate an individual is taxed, with the consequence that state taxes will distort where taxpayers reside, how much they work, and where they choose to work.

But those kinds of locational distortions are not the evil the dormant commerce clause was designed to prevent. Indeed, one of the purposes of our federal system is to facilitate regulatory and even tax competition among the states. Rather than preventing competition among the states for residents and workers, the dormant commerce clause aims to prevent market segmentation — cases in which a state uses its tax system to encourage nonresidents to stay out and residents to stay in. And as long as states enact uniform source and residence taxes, taxes will not distort competition (because they will not produce differences in retention ratios) across taxpayers residing in different states even though some taxpayers will end up paying no tax, others will pay tax to only one state, and still others will pay tax to two states.[70]

V. Conclusion

In the Court's language, the crucial question under the dormant commerce clause is whether a state tax policy "establishes an economic barrier against competition" or an "unreasonable clog upon the mobility of commerce."[71] As the discussion above makes clear, the Maryland county tax discourages interstate commerce in favor of in-state commerce. The tax regime adversely affects both residents with out-of-state income and nonresidents with in-state income. Failure to hold that the Maryland county tax violates the dormant commerce clause would open the door for states to use their tax systems to discriminate against interstate commerce.

In contrast, the internal consistency test represents a rare bit of firm ground in the morass of the Court's dormant commerce clause doctrine. It is logical, intuitive, easy to apply, and well supported by economics, and the Court should not narrow its application. ✰

[67]Hellerstein and Hellerstein, *State Taxation*, *supra* note 63, para. 4.16[1][b]. Note that to satisfy internal consistency, Maryland has to increase its foreign tax credit only by the SNRT rate of 1.25 percent. For a discussion of the requirements for state taxes not to distort interstate commerce when the taxing state is offering a credit for taxes paid to other states (which differ from those when the state is not offering a credit), see Mason and Knoll, "What Is Tax Discrimination?" *supra* note 8, at 1063-1064, 1072-1074.

[68]This is calculated as 3.2 percent + 1.25 percent - (3.2 percent x 1.25 percent) = 4.41 percent.

[69]*Wynne*, argument transcript, at 36.

[70]For an example showing that internally consistent (i.e., uniform) double taxes do not distort competition, see Mason and Knoll, "Waiting for Perseus," *supra* note 8, at 442-452.

[71]*Moorman Mfg. Co.*, 437 U.S. at 287-288 (Powell, J., dissenting).