12-21-2015

How the Massachusetts Supreme Judicial Court Should Interpret *Wynne*

Michael S. Knoll
University of Pennsylvania Carey Law School

Ruth Mason
University of Virginia - Main Campus

How the Massachusetts Supreme Judicial Court Should Apply *Wynne*

by Michael S. Knoll and Ruth Mason

Michael S. Knoll

Ruth Mason

Michael S. Knoll is deputy dean and Theodore Warner Professor, University of Pennsylvania Law School; professor of real estate, the Wharton School; and co-director, Center for Tax Law and Policy, University of Pennsylvania. Ruth Mason is Hunton & Williams Professor of Law at the University of Virginia School of Law. Thanks to Lee Barkley and Alvin Dong for assistance with the research.

In this special report, Knoll and Mason discuss how the Massachusetts Supreme Judicial Court should apply *Wynne* when it hears on remand *First Marblehead v. Commissioner of Revenue*. The authors conclude that when it originally heard the case, the Massachusetts court mistakenly considered, as part of its internal consistency analysis, whether Gate Holdings Inc. experienced double state taxation. As developed by the U.S. Supreme Court and most recently applied in *Wynne*, the internal consistency test is not concerned with actual double taxation that may arise from the interaction of different states' laws. Rather, the test is designed to determine whether the challenged state's law alone discriminates against interstate commerce. The authors show how this standard applies to the challenged Massachusetts apportionment rules, and they conclude that in order to ascertain the constitutionality of the challenged Massachusetts law, the Massachusetts court must determine how the other states would tax Gate if the other states applied Massachusetts law for non-domiciled taxpayers.

In October the U.S. Supreme Court remanded *First Marblehead Corp. v. Massachusetts Commissioner of Revenue*[1] so that the Massachusetts courts could apply the U.S. Supreme Court's decision in *Comptroller of the Treasury of Maryland v. Wynne*.[2] *First Marblehead* represents the first opportunity after *Wynne* for a state's highest court to reconsider a tax discrimination case.[3] In this article, we show how *Wynne* applies in *First Marblehead*.

First Marblehead: Statutory Argument

For the tax years in question (2004-2006), First Marblehead Corp. (FMC) was a publicly traded corporation with its principal place of business in Boston. FMC was the principal tax reporting entity for itself and several other related entities. Gate Holdings Inc., one of those related entities, was a limited liability company domiciled in Massachusetts. FMC and Gate were involved in securitizing student loans. Gate, whose taxes are at the center of the dispute, held beneficial interests in trusts that held student loans. Those beneficial interests were essentially the only property Gate held, and substantially all of Gate's income was from interest on the student loans in which it held beneficial interests. As described by the Massachusetts court, Gate "was essentially a holding company with no employees, payroll, tangible assets or office space."[4]

Gate and FMC were long embroiled in Massachusetts tax disputes. However, by the time the case reached the state's supreme court, the only unresolved issue involved Gate. Under Massachusetts law, Gate was entitled to apportion its income between Massachusetts and other states. Massachusetts law provides that a financial institution can apportion its income based on the average of the institution's receipts, payroll, and property factors. Each factor is determined by dividing the institution's in-state receipts, payroll, and property by its total worldwide receipts, payroll, and property.

Because Gate had no employees, its payroll factor dropped out of the formula, and thus Gate's income was

---

[1] *First Marblehead Corp. v. Mass. Commissioner of Revenue*, No. 14-1422 (Oct. 13, 2015), vacating and remanding.

[2] 575 U.S. ___ (2015) (all internal citations are to the slip opinion); *see also Maryland State Comptroller of the Treasury v. Wynne,* 64 A.3d 453 (Md. 2013).

[3] The Supreme Court issued *Wynne* on May 18, 2015, and the Massachusetts Supreme Judicial Court issued its opinion in *First Marblehead* on January 28, 2015.

[4] *First Marblehead Corp. v. Commissioner of Revenue*, 470 Mass., 497 (S. Ct. Mass. 2015). *First Marblehead*, slip op. at 5.

apportioned to Massachusetts based on the average of its receipts and property factors. Gate's receipts factor was roughly 2 percent because roughly 2 percent of the borrowers on the loans it held resided in Massachusetts.

By the time the case reached the Massachusetts Supreme Judicial Court, the only issue remaining in *First Marblehead* was how to calculate Gate's Massachusetts property factor. As the court described the issue:

> We must determine whether the loan portfolios that represented substantially all of Gate's property for the tax years at issue should be treated as having been located in whole or in part within the Commonwealth, and thus included in the numerator of Gate's property factor fraction, or outside of the Commonwealth, and therefore excluded from the numerator and included only in the denominator.[5]

The Massachusetts commissioner of revenue argued that all of the loans should be allocated to Massachusetts for the purpose of calculating Gate's property factor (property factor 100 percent), thereby yielding an apportionment fraction of 51 percent and thus subjecting 51 percent of Gate's income to tax in Massachusetts.[6] In contrast, FMC and Gate argued that for the purpose of calculating the property fraction, all of the loans should be considered property outside Massachusetts (property factor 0), thereby rendering only 1 percent of Gate's income subject to tax in Massachusetts.[7] The tax difference for the three years using the 51 percent rather than the 1 percent allocation fraction was more than $4 million.

The Massachusetts Supreme Judicial Court determined that the relevant rule for apportioning Gate's loans was the following[8]:

> In the case of a loan which is assigned by the taxpayer to a place without the commonwealth which is not a regular place of business, it shall be presumed, subject to rebuttal by the taxpayer on a showing supported by the preponderance of evidence, that the preponderance of substantive contacts regarding the loan occurred within the commonwealth if, at the time the loan was made the taxpayer's commercial domicile . . . was within the commonwealth.[9]

In other words, Massachusetts presumptively assigns a loan to Massachusetts if, when the loan was made, the owner of the loan was domiciled in Massachusetts and the owner had no regular place of business anywhere.

Relying on the phrase "at the time the loan was made," Gate argued that the presumption applies only in the context of an original lender. Gate argued that because it was not the original lender (Gate had acquired its interest in the loans after the loans were originated), the presumption did not apply. In contrast with Gate's view, the Massachusetts Supreme Judicial Court concluded that the purpose of the phrase "at the time the loan was made" is to resolve any ambiguity were the taxpayer to change domicile after the loan was originated.[10] That is, if the taxpayer lacks a regular place of business, the statute presumptively allocates the loans to Massachusetts if the taxpayer's commercial domicile was Massachusetts at the time of origination, even if the taxpayer moves its commercial domicile after origination. Accordingly, the Massachusetts supreme court concluded that the presumption applies to Gate.

Having lost its argument on whether the presumption should apply, Gate then sought to overcome the presumption by showing that a "preponderance of substantive contacts regarding the loan" occurred outside Massachusetts.[11] The relevant Massachusetts law for ascertaining the state in which a preponderance of substantive contacts for a loan is:

> To determine the state in which the preponderance of substantive contacts relating to a loan have occurred, the facts and circumstances regarding the loan at issue shall be reviewed on a case-by-case basis and consideration shall be given to such activities as the solicitation, investigation, negotiation, approval and administration of the loan.[12]

The court concluded that administration was the only one of the five factors that could possibly apply to Gate "because all the other factors listed relate to the origination of loans and Gate played no role in loan origination."[13] The Massachusetts Supreme Judicial Court further held that none of the activities that Gate or affiliated loan servicers provided constituted "administration" as defined by the statute. This effectively knocked out the last of the five factors in the facts and circumstances test, and, as a result, the court concluded that for purposes of Massachusetts tax law, the loans had "no 'substantive contacts'" with any

---

[5] *First Marblehead*, slip op., at 12-13.

[6] With a property factor of 100 percent, the apportionment fraction would be 51 percent, the arithmetic mean of 2 percent and 100 percent.

[7] With a property factor of 0, the apportionment fraction would be 1 percent, the arithmetic mean of 2 percent and 0.

[8] The court's conclusion that this rule applied was based on its holding that Gate had no "regular place of business" in Massachusetts or elsewhere to which the loans could be assigned.

[9] Mass. G.L. Ann. 63 section 2A(e)(vi)(B).

[10] In rejecting Gate's interpretation, the court reasoned as follows: "[The reading urged by Gate] would leave open the possibility that loans qualifying as property of the taxpayer could exist without being assigned anywhere. This is clearly an unintended and ultimately absurd result." *First Marblehead*, slip op, at 17.

[11] Mass. G.L. Ann. 63 section 2A(c)(vi)(C).

[12] *Id.*

[13] *First Marblehead*, slip op., at 19. Gate might have been better off arguing that the time of origination language applies to loans whether held by the originator or not and so the location of property does not change with ownership. Anyway, we conduct our constitutional analysis based on the statute as interpreted and enforced by Massachusetts.

state.[14] Accordingly, Gate had not overcome the statutory presumption, and the loans were properly assigned to Gate's commercial domicile of Massachusetts. The court therefore calculated the Massachusetts property factor to be 100 percent, which yielded an apportionment fraction of 51 percent. Thus, for Gate the rebuttable statutory presumption effectively could not be rebutted, and so all of the loans were considered Massachusetts property, which resulted in Gate owing Massachusetts $4 million in tax.

Dormant Commerce Clause Challenge

The U.S. Supreme Court has interpreted the commerce clause of the U.S. Constitution to promote a single national marketplace in which taxpayers residing in different states can compete on a level playing field.[15] Specifically, the U.S. Supreme Court has interpreted the clause to prohibit states from discriminating against out-of-state parties and to require apportionment formulas to be fair. Gate argued that the Massachusetts tax (as interpreted by the Massachusetts courts) violated the dormant commerce clause because it was not fairly apportioned. Although the Massachusetts Supreme Judicial Court purported to apply the internal consistency test and found the Massachusetts tax to be internally consistent and therefore not unconstitutional,[16] on petition for writ of certiorari, the U.S. Supreme Court vacated and remanded the case so that the Massachusetts court could reconsider it in light of *Wynne*.[17]

Wynne: Reinvigorating Internal Consistency

In *Wynne* a sharply divided Court, relying on the internal consistency test, struck down a Maryland state income tax on the ground that the tax violated the dormant commerce clause. Prior to *Wynne* the Court evoked the test in eight cases and used it to strike down a state statute in three. Nevertheless, the Court had been narrowing the test in recent years and had not rejected a state tax for failing the internal consistency test for roughly 30 years. In striking down the Maryland statute and reinvigorating the test, the *Wynne* Court relied on an amicus brief we wrote and another, similar brief submitted by eight tax economists and principally written by Alan Viard.[18] The two briefs provided the economic underpinnings for the internal consistency test, and the Court described the economic analysis in these two briefs as "undisputed."[19]

In urging the Court to strike down the Maryland statute because it was internally inconsistent, we argued that, as interpreted by the Supreme Court, the dormant commerce clause does not prevent *double taxation* as such, but rather it prevents *discrimination against interstate commerce*. Double taxation is neither a necessary nor sufficient condition for discrimination. As we have explained at length in a series of articles, avoiding discrimination requires that state taxes be uniform.[20] A source tax is uniform if it applies at the same rate and on the same base to all taxpayers with income sourced in that jurisdiction, regardless of their residence. A residence tax is uniform if it applies at the same rate and on the same base to all income earned by taxpayers resident in that state, regardless of the source of their income.[21] Apportionment rules are sourcing rules, so under our analysis, to avoid discrimination, a state must apply the same allocation rules to residents and nonresidents (or domiciliaries and non-domiciliaries). We showed in our brief and in several short pieces published after we submitted our brief that the internal consistency test is an easy way to check for uniformity in a state's tax rates.[22]

Twenty years ago in *Jefferson Lines*, the Supreme Court gave its clearest and most widely cited statement about how to apply the internal consistency test, writing that:

> 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.[23]

---

[14]*Id.* at 904.

[15]*See H.P. Hood & Sons Inc. v. Du Mond*, 336 U.S. 525 (1949); *Okla. Tax Commission v. Jefferson Lines Inc.*, 514 U.S. 175 (1995); *Hughes v. Oklahoma*, 441 U.S. 322 (1979); and *Armco Inc. v. Hardesty*, 467 U.S. 638 (1984).

[16]The way the Massachusetts court applied the test accorded neither with *Wynne* nor earlier precedent on the internal consistency test. Contrary to *Wynne* and other precedent, the Massachusetts court checked only whether Gate suffered actual double state taxation. As we explain later, that is an improper application of internal consistency.

[17]*First Marblehead*, *supra* note 1.

[18]Brief for Michael S. Knoll and Ruth Mason as Amici Curiae; Brief for Tax Economists as Amici Curiae. In addition to these two briefs, friends of the court filed 12 other briefs in *Wynne*, including the solicitor general, who filed an amicus brief for the United States in support of Maryland.

[19]*Wynne*, at 22.

[20]Mason and Knoll, "Waiting for Perseus: A Sur-Reply to Professors Graetz and Warren," 67 *Tax L. Rev*. 375 (2014) [hereinafter Waiting]; Mason and Knoll, "A Brief Sur-Reply to Professors Graetz and Warren," 123 *Yale L.J.* Online 1 (2013); and Mason and Knoll, "What Is Tax Discrimination?" 121 *Yale L.J.* 1014 (2012).

[21]In effect, uniformity requires that states tax their residents on their domestic-source income by applying both the tax they assess on their residents' out-of-state income and the tax they assess on nonresidents' in-state income.

[22]Knoll and Mason, "*Comptroller v. Wynne*: Internal Consistency, A National Marketplace, and Limits on State Sovereignty to Tax," 163 *U. of Penn. L. Rev.* Online 267 (2015); Knoll and Mason, "*Wynne*: It's Not About Double Taxation," *State Tax Notes*, Feb. 16, 2015, p. 413 (2015); Brief of Knoll and Mason.

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

Thus, the internal consistency test directs a court to assume that every state enacts the challenged state's tax regime, and then it asks whether, under such hypothetical harmonization, interstate commerce bears more tax than purely in-state commerce. Notwithstanding that it purported to apply the internal consistency test, the Massachusetts Supreme Judicial Court did not apply the test properly in *First Marblehead*. Rather than hypothetically assuming that all states used Massachusetts's apportionment rules, the Massachusetts court instead looked to see whether Gate experienced *actual* double taxation. We assume that was why the Supreme Court granted certiorari, vacated the court's opinion, and remanded the case for further consideration.

In applying the internal consistency test on remand in *First Marblehead*, the Massachusetts court should assume that all other states enact the Massachusetts income tax law and then the court should determine whether the tax burden on cross-border commerce is higher than that on purely in-state commerce. That is the test from *Jefferson Lines*, and the Supreme Court endorsed it in *Wynne*.[24] Although the internal consistency test strikes some as counterintuitive because it is counterfactual, not only has the Supreme Court unequivocally endorsed the approach, but economic analysis shows that the internal consistency test works better than raw intuition and better than comparing absolute tax rates in determining whether a state discriminates against interstate taxation.[25]

Note that while the internal consistency test asks whether interstate commerce bears more tax than purely domestic commerce under the counterfactual assumption that all states apply the challenged rule, the test does not rule out actual double tax. The test may "pass" state tax regimes notwithstanding that the taxpayer at issue is subject to actual double taxation. Likewise, the test may "fail" state tax regimes even though the taxpayer suffered no actual double tax. For example, as the Supreme Court noted in *Wynne*, an internally consistent state tax regime that taxed only on a source basis would not violate the dormant commerce clause.[26] At the same time, an internally consistent state tax regime that taxed only on a residence basis would also not violate the dormant commerce clause.[27] If different states adopted each regime, cross-border taxpayers might suffer actual double taxation, even though no state would have violated the dormant commerce clause. That is because internal consistency is a test for discrimination, not double taxation. The form the test takes makes it possible to determine whether there is a discriminatory effect from a simple comparison. The alternative but direct way of making such a discrimination determination would involve complex economic analysis, a task we undertook in some of our earlier work.[28] Below we provide a simple example.

The internal consistency test is easy to apply when, as in *Wynne*, the taxpayer challenges the state's rate structure. Brian and Karen Wynne challenged the constitutionality of a Maryland tax regime that imposed a 3.2 percent tax on both the domestic (T_d) and outbound incomes (T_o) of residents and a 1.25 percent tax on the inbound incomes of nonresidents (T_i). We illustrate the tax regime challenged in *Wynne* in Table 1. The left column represents Maryland residents and the right column nonresidents. Residents and nonresidents can earn income in Maryland (bottom row) or outside Maryland (top row). Maryland will tax Maryland residents at 3.2 percent on their Maryland income (bottom left quadrant) and on their out-of-state income (top left quadrant); Maryland will also tax nonresidents at 1.25 percent on their Maryland income (bottom right quadrant). Maryland, however, because of a lack of nexus, does not and cannot tax the non-Maryland income of nonresidents (the top right quadrant).

Table 1.
Challenged Maryland 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* $T_i = 1.25\%$

The U.S. Supreme Court struck down the Maryland tax as violating the dormant commerce clause because the Maryland tax failed the internal consistency test. When we counterfactually assume that every other state adopts Maryland's tax regime, cross-border economic activities suffer more tax than purely domestic activities, a point illustrated in Table 2:

Table 2.
Challenged Maryland Tax Under The Internal Consistency Test

	Tested State Resident (Marylander)	**Resident of Another State**
Activity in Another State	$T_i + T_o = 4.45\%$	$T_d = 3.2\%$
Activity in Tested State (Maryland)	$T_d = 3.2\%$	$T_i + T_o = 4.45\%$

The shaded quadrants represent cross-border activity. For the two cross-border quadrants, the assumption that all

[24] *Wynne*, at 21-26.

[25] *See* authors' brief cited in *supra* note 18 and articles cited *supra* note 20.

[26] *Wynne*, at 22-23.

[27] *Wynne*, at 22-23.

[28] *See* articles cited in *supra* note 18.

states adopt the Maryland tax system implies that the income in these quadrants is taxed more heavily when it crosses borders than when it does not. In the top left quadrant, the inbound tax (T_i) combines with the outbound tax (T_o) to increase the burden on Marylanders' out-of-state activities, and in the lower right quadrant, the inbound tax (T_i) combines with the outbound tax (T_o) to increase the burden on non-Marylanders' activities in Maryland. Accordingly, the in-state income of residents is subject to the domestic tax only (T_d), whereas cross-border income is subject to both the inbound tax (T_i) and the outbound tax (T_o). Put simply, the Maryland tax regime is internally inconsistent because interstate income bears more tax (4.45 percent — shaded regions) than purely in-state income (3.2 percent — unshaded regions).[29]

We have long argued that a court cannot determine whether a state's tax rate regime discriminates against interstate commerce unless the court analyzes how the state taxes both inbound and outbound income.[30] Specifically, to ascertain whether a state's tax structure is internally consistent, a court must compare the state's rate on residents' domestic income with the sum of the state's rates on residents' out-of-state and nonresidents' in-state income. The state's tax rate regime is internally consistent only if the domestic tax rate equals or exceeds the total of the state's outgoing plus incoming tax rates. We further argued that courts cannot view source taxes in isolation from residence taxes lest courts miss discrimination that results from the interaction of source and residence taxes.[31] Application of the internal consistency test forces courts to take a comprehensive view of the challenges raised against state tax regimes and therefore avoids error.

Applying *Wynne* to *First Marblehead*

The internal consistency test can be more difficult to apply in a case such as *First Marblehead*, in which the challenge is not to the state's system of tax rates but rather to how income is sourced or allocated by the state. One reason why it can be more difficult to apply the internal consistency test to a state's sourcing tax rules than to its tax rate structure is that the rate structure is typically clear and well established. In contrast, a state's sourcing rules are often drafted in an ambiguous and incomplete way that produces gaps in guidance on how those rules are applied. In these circumstances, there can be substantial uncertainty as to where various items of income are sourced. Nonetheless, even if a state's sourcing rules are unclear, the internal consistency test provides a simple and powerful technique that courts can use to ascertain whether the state's tax laws are unconstitutional. Likewise, administrators and courts can use the same approach to resolve statutory ambiguities and enforcement questions in ways that avoid constitutional violations.

Application of the internal consistency test — counterfactual assumption of 50-state tax harmony — to sourcing rules is similar to applying the internal consistency test to tax rates but with a twist. As with tax rates, with sourcing rules we compare (a) the domestic tax to (b) the sum of (1) the inbound tax and (2) the outbound tax. The twist is that since we cannot check for *higher tax rates* (because the constitutional challenge does not involve rates), we must instead look to *how much income* is subject to taxation. Specifically, we compare (a) the portion of a purely domestic taxpayer's income allocated to the taxpayer's state of domicile with (b) the sum of (1) the portion of the taxpayer's cross-border income allocated to the challenged state and (2) the portion the taxpayer's of cross-border income allocated to other states when they apply the challenged state's allocation rule under the 50-state harmony assumption. That is, the court compares the (a) domestic allocation with (b) the sum of (1) the inbound allocation and (2) the outbound allocation.

In most cases, when a taxpayer operates exclusively in its state of domicile, that state will tax 100 percent of its income.[32] Thus, in most cases (a) will be equal to 100 percent. This means that we can simplify our inquiry and ask whether the following sum exceeds 100 percent of the taxpayer's income: (1) the taxpayer's cross-border income allocated to the challenged state plus (2) the taxpayer's cross-border income that other states would allocate to themselves if they applied the challenged state's allocation rules.[33] If the sum exceeds 100 percent, the challenged state's allocation rule fails the internal consistency test and violates the dormant commerce clause. This makes sense; if,

---

[29]Under the harmony assumption, on cross-border income, taxpayers would pay a tax of 1.25 percent to the state where the income arose and a tax of 3.2 percent on their state of residence. Because there were no credits, the total tax would be 4.45 percent.

[30]*See, e.g.,* Georg W. Kofler and Mason, "Double Taxation: A European Switch in Time?" 14 *Colum. J. Eur'n L.* 63, 88-94 (2007); Mason, "Made in America for European Tax: The Internal Consistency Test," 49 *B.C. L. Rev.* 1277, 1309-1319 (2008) [hereinafter Made]; Mason and Knoll, "What Is Tax Discrimination?" *supra* note 20, at 1105; and Mason and Knoll, Waiting, *supra* note 20, at 425-429.

[31]*See, e.g.,* Mason and Knoll, Waiting, *supra* note 20, at 425-429. *See also* Mason, Made, *supra* note 30 at 1309-1315. *Id.* at 1315 ("the internal consistency test, gives the court an overall [source and residence] perspective on how the income will be taxed. . . [while] avoid[ing] the risk that interactions between particular. . . source rules and particular. . . residence rules create the appearance of discrimination. . . or obscure discrimination").

[32]For a financial institution domiciled in Massachusetts that is holding loans, the assumption that all of the institution's economic activity takes place in Massachusetts implies the following: The holder (if it is physically located anywhere) is located in Massachusetts, the borrowers are all located in Massachusetts, and all of the activities relating to the loans, which is to say, "the solicitation, investigation, negotiation, approval and administration of the loan[s]" takes place in Massachusetts. Mass. G.L. Ann, 63 section 2A(e)(vi)(C).

[33]This test is equivalent to the uniformity rule we described above and in our prior academic work. *See* Mason and Knoll, "What Is Tax Discrimination?" 121 *supra* note 20, at 1076-85.

under the 50-state harmony assumption (that is, under internal consistency), a state's allocation rules result in allocation of more than 100 percent of a multistate enterprise's income, its law creates a preference for domestic over cross-border commerce.

We illustrate this approach with the challenged regime in *First Marblehead*. Because it is the only issue in the case, we focus exclusively on the disputed property apportionment rule. To test Massachusetts's allocation rule for internal consistency, on remand the Massachusetts court should add (1) the portion of Gate's income Massachusetts would allocate to Massachusetts under the state's property allocation rule and (2) the portion of Gate's income other states would allocate to themselves *using the challenged Massachusetts property allocation rules*. If that sum is more than all of Gate's income (that is, more than 100 percent), the challenged sourcing rule fails the internal consistency test and violates the dormant commerce clause.[34]

Putting numbers to this approach, we proceed as follows:

- The Massachusetts Supreme Judicial Court interpreted the challenged state allocation rule to allocate all of Gate's property to Massachusetts for the purpose of calculating the property factor. Under our simplifying assumption that this was the only factor in the formula, that means that Massachusetts allocates to itself 100 percent of Gate's income.
- We next determine how much of Gate's property other states would allocate to themselves if they employed the Massachusetts property allocation rule to *Gate as a non-domiciliary*. This amount must be zero for the rule to pass the internal consistency test. If, using allocation rules identical to those of Massachusetts, another state would allocate to itself any of Gate's property, the Massachusetts allocation rule is internally consistent because it allocates more than 100 percent of Gate's income. Notice that this is just a restatement of the uniformity rule we have described in our academic work.[35]

Any internal inconsistency in Massachusetts law would be a violation of the dormant commerce clause, even if no other state taxed Gate and thus Gate suffered no actual double taxation. *Wynne* makes that clear.[36] *Wynne* also makes clear that if the Massachusetts allocation rule passes the internal consistency test, the Massachusetts rule passes constitutional muster, even if Gate suffers actual double taxation, for example because another state uses a different allocation rule than Massachusetts.[37] Thus, in light of *Wynne*, the Massachusetts Supreme Judicial Court would err if on remand it decides *First Marblehead* by checking to see if Gate was subject to actual double taxation. That fact is not relevant to the dormant commerce clause as interpreted by the U.S. Supreme Court in *Wynne*.

Getting back to the second step of our internal consistency analysis, how would other states (counterfactually applying Massachusetts law) apportion the loans held by Gate, a company with an out-of-state domicile?[38] Answering this question requires us to examine how Massachusetts law treats loans held by non-domiciled companies. The Massachusetts statute (described above) presumes that the property is allocable to Massachusetts if the taxpayer's domicile is in Massachusetts. Another state, say Connecticut, applying Massachusetts law, would not apply the presumption because Gate is not domiciled in Connecticut.

When the presumption does not apply, the Massachusetts statute says that a loan is considered to be located in the state with which the loan has the preponderance of contacts, a determination made on a case-by-case basis by considering five factors: solicitation, investigation, negotiation, approval, and administration. The Massachusetts high court already held that none of these factors applied in *Gate* because Gate does not engage in any of the relevant activities. If that holding leads to the conclusion that, under the counterfactual posed by the internal consistency test, Connecticut would not be able to allocate any of Gate's loans to itself under the Massachusetts allocation rules, the Massachusetts formula would be internally consistent.

But this conclusion is not entirely clear. To satisfactorily resolve the case by applying the internal consistency test, the Massachusetts court must determine how the other states would apply Massachusetts's apportionment rule to Gate as a nondomiciliary. The Massachusetts statute is unclear on the point, and we are not familiar enough with state practice to provide an answer with any confidence as to how Massachusetts would tax a nondomiciliary that held loans taken out by Massachusetts residents. Accordingly, we cannot say whether Massachusetts's method for calculating the property factor of the apportionment formula for financial institutions is internally consistent and hence constitutional or internally inconsistent and hence unconstitutional.

Although we are unsure which way *First Marblehead* should come out on remand, *Wynne* and the internal consistency test provide the lower courts with clear direction.

---

[34]Unless the Massachusetts apportionment formula can somehow be justified, which is not an issue we address in this essay.

[35]Mason and Knoll, "What Is Tax Discrimination?" *supra* note 20, at 1060-1074.

[36]*Wynne*, at 22-23.

[37]*Wynne*, at 22-23.

[38]Under the inquiry, the other state applies Massachusetts's allocation rules, but even under the harmony assumption, no state except Massachusetts can presumptively allocate to itself the loans on account of Gate's domicile, because Gate is domiciled only in Massachusetts. So under the harmony constraint, the other states would look to provisions of Massachusetts law that apply to non-domiciliaries to determine how much of Gate's income they can allocate to themselves. It is crucial under the internal consistency test for the court to get an overall — domestic, inbound, and outbound — view of the challenged state's tax system, and the internal consistency test facilitates that perspective.

What a court would need to know to apply the internal consistency test and ascertain whether the Massachusetts sourcing rules are constitutional as applied to Gate is how Massachusetts treats the nondomiciliary situation when Massachusetts *non-domiciliaries* hold loans that have connections to Massachusetts.[39]

Final Observations

A state tax violates the dormant commerce clause when it discourages cross-border commerce relative to in-state commerce. Determining whether a tax discourages cross-border commerce calls for analysis of how a state taxes all of domestic, inbound, and outbound commerce. This is as true of apportionment rules as tax rates. We cannot ascertain whether Massachusetts allocation rules discriminate against interstate commerce by looking only at how those rules apply to Massachusetts domiciliaries. Instead, we must also determine how those rules would apply to similarly situated non-domiciliaries. The internal consistency test aids the courts in gaining the overarching perspective needed to evaluate allocation rules in the same way it facilitates that perspective on rates. Because the internal consistency test effectively requires the reviewing court to apply the challenged state's own rules to both insiders and outsiders while eliminating from the inquiry the impact of any other state's rules, the test focuses the court's attention where it should be.[40]

As the above discussion suggests, the internal consistency test also provides states with wide latitude in designing and implementing their tax systems. States have great flexibility in writing sourcing rules, but when it comes to drafting and enforcing such rules, internal consistency formalizes the principle "what is good for the goose is good for the gander." Whatever sourcing rules (and presumptions and burdens of proof and persuasion) apply when the state allocates income to itself also when apportioning income to nondomiciliaries. If that does not happen, then the state's tax rules are not internally consistent and therefore are presumptively unconstitutional.

To make this point clear, note that Massachusetts could have made the property factor allocation rule irrebuttable and still maintained internal consistency. Thus, Massachusetts law could have said that if a financial institution lacks a regular place of business and is domiciled in Massachusetts, its loans are irrebuttably presumed to be in Massachusetts for the purpose of calculating its property factor. However, if that were the Massachusetts rule, the commonwealth would not be able to allocate to itself any such loans for nondomiciliaries. That is, when the tables were turned and Massachusetts was determining how to tax a non-domiciliary with no regular place of business, it could not allocate any of those loans to itself.

It is also important to keep in mind that when sourcing rules are examined in a piecemeal situational context, a court cannot approve the sourcing rules against all challenges. It is possible for a state's sourcing rules to be internally consistent regarding a specific situation but not another situation. For example, the above discussion focused on the sourcing rules when a financial institution did not have a regular place of business. Even if Massachusetts had the same set of written sourcing rules for financial institutions that have a regular places of business as it does for those without a regular place of business, Massachusetts might apply those rules differently. In this circumstance, the Massachusetts rule as applied to financial institutions with a regular place of business might be internally consistent, but those same rules as applied to financial institutions without a regular place of business might not be. Accordingly, the determination of the internal consistency of those rules for financial institutions lacking a regular place of business would say nothing about the internal consistency of those rules for financial institutions with a regular place of business.

Also, courts will have to decide what to do about provisions — like the following one from Massachusetts law — that allow an administrative redetermination of the allocation in cases in which the statutory allocation does not adequately reflect the taxpayer's activities in the state:

> if the provisions of subsections (*a*) to (*f*), inclusive, are not reasonably adapted to approximate the net income derived from business carried on within the commonwealth, a financial institution may apply to the commissioner, or the commissioner may require the financial institution, to have its income derived from business carried on within this commonwealth determined by a method other than that set forth in subsections (*a*) to (*f*), inclusive.[41]

---

[39]Massachusetts's use of a preponderance of the evidence standard, which is generally interpreted as meaning more likely than not (or just over 50 percent), implies that the same standard (or a stricter standard) must apply in the hypothetical nondomiciliary situation when the taxpayer is domiciled outside Massachusetts if the Massachusetts law is to be upheld. Similarly, the Massachusetts law provides a burden on the taxpayer, although proof is only by a preponderance of the evidence, which implies that in the converse situation Massachusetts would have the burden of advancing to assert taxation of a non-domiciliary.

Internal consistency does not require that Massachusetts have a preponderance of the evidence standard. Massachusetts could have required, for example, clear and convincing evidence that the preponderance of the contacts were with a state other than the state of the taxpayer's domicile. However, in that case internal consistency would require in the converse case that Massachusetts establish by clear and convincing evidence that the preponderance of the contacts were with Massachusetts.

[40]*See* amicus brief cited, *supra* note 18; Mason and Knoll, Waiting, *supra* note 20, at 425-429; Mason and Knoll, "*Wynne*: It's Not About Double Taxation," *supra* note 22, at 415-422; and Mason, Made, *supra* note 30, at 1307-1308, 1315-1316.

[41]Mass. Gen. L. Ann. 63 section 2A (g).

Granting the taxpayer an option to request a reallocation seems like it would be permissible under the dormant commerce clause, as long as the state administers it in a nondiscriminatory fashion. But the existence of the opportunity to request a reallocation should not shield state tax allocation rules that are internally inconsistent. The Court of Justice of the European Union has considered whether the availability of administrative procedures to correct over-assessments stemming from discriminatory taxation save the discriminatory rule. The CJEU has held that such administrative procedures cannot save discriminatory legislation, unless the administration has no discretion not to cure the discrimination.[42] Moreover, the possibility that the state tax commissioner would seek to reallocate the taxpayer's income creates legal uncertainty that may be subject to challenge under the dormant commerce clause as discriminatory (if there is discretion that would allow the rule to be administered in a discriminatory fashion) or as an undue burden on interstate commerce.

We make one final observation and a conjecture. The internal consistency test is often misunderstood as a test for double taxation. As a test for double taxation, it has been criticized as poorly tailored and counterfactual. We have argued,[43] and the Supreme Court in *Wynne* agreed,[44] that internal consistency is not specifically a test for double taxation but rather a test for discrimination. The two concepts are distinct and overlap only sometimes.

One of the circumstances in which double taxation and discrimination (that is, discouraging cross-border commerce) overlap is in evaluating challenges to sourcing rules. The internal consistency test requires comparing (a) the domestic tax treatment with (b) the sum of (1) inbound and (2) outbound tax treatments. When all of a taxpayer's economic activity occurs in the state in which the taxpayer resides or is domiciled (that is, in a purely domestic situation), all of the taxpayer's income from that activity is sourced (allocated) in the state of the taxpayer's residence or domicile. In other words, (a) is equal to 100 percent. Thus, when the challenge is to the sourcing rules, we almost always compare the sum of the inbound and outbound situations to 100 percent. In these circumstances, the sourcing rule passes the test if in the inbound plus outbound situation no more than 100 percent of income is hypothetically taxed. Thus, when the challenge is to the sourcing rules, the internal consistency test is in effect a test for *hypothetical* double taxation, but that is because when there is such hypothetical double taxation, the state's allocation rules discourage interstate commerce. That is, it is a case of *discriminatory* (hypothetical) double taxation. In situations involving tax rates and the tax base, there is no such natural correspondence because there is no natural baseline with 100 percent taxation.

The Supreme Court first developed the internal consistency test to evaluate the constitutionality of allocation rules. Only later did the internal consistency test become a more general test for discrimination. Thus, the internal consistency test developed in a context in which the concern was closely connected with double taxation. We conjecture that this might be one reason the internal consistency test is so often mistakenly thought to be a test for double taxation. ✰

[42]Compare *Biehl v. Administration des Contributions de Luxembourg*, C-175/88 (CJEU 1990) (*Biehl I*) (holding that the availability of a procedure to seek a tax refund did not overcome the discriminatory violation of the freedom of movement of workers inherent in denying automatic refunds to nonresidents, in part because there was no "obligation on the Administration . . . to remedy in every case the discriminatory consequences arising from the application of the national provision") *with Safir v. Skattemyndighten*, C-118/96 (CJEU 1998) (holding that a state's requirement that a nonresident EU national undergo an administrative proceeding to determine its entitlement to a tax benefit was not discriminatory, as long as the tax administrator had no discretion to deny the benefit to qualified applicants). *See also Commission of the European Communities v. Luxembourg,* C-151/94 (CJEU 1995) *(Biehl II)* (holding that Luxembourg had to amend its law to eliminate the restriction on the freedom of movement found by the Court in *Biehl I* because a mere administrative proceeding to remedy violations on a case-by-case basis was not sufficient).

[43]*See* articles and brief cited in *supra* notes 18 to 22.
[44]*Wynne*, at 22-23.