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In this article, the authors discuss *Steiner v. Utah* and how Utah could revise its tax system to satisfy the Constitution.

Introduction

In an earlier article in this publication,[1] we argued that the Utah Supreme Court failed to follow and correctly apply clear U.S. Supreme Court precedent in *Steiner v. Utah*[2] when the Utah high court held that an internally inconsistent and discriminatory state tax regime did not violate the dormant commerce clause. Unfortunately, the Supreme Court recently declined certiorari in *Steiner*,[3] but the issue is unlikely to go away. Not every state high court will defy the U.S. Supreme Court by refusing to apply the dormant commerce clause, and so the Court will sooner or later likely find itself facing conflicting interpretations of the dormant foreign commerce clause. Accordingly, in this article we address an issue that we did not cover in our earlier article: how Utah could revise its tax system to satisfy the Constitution.

The Case: *Steiner v. Utah*

As we explained at greater length in our first article on *Steiner*, the challenged Utah tax regime is internally inconsistent, and hence it unconstitutionally violates the dormant foreign commerce clause. First introduced in 1983 in *Container Corp.*,[4] and emphatically reinforced in 2015 in *Wynne*,[5] the internal consistency test requires a court evaluating a dormant commerce clause challenge to a state tax to assume that all other jurisdictions (typically depicted as a single hypothetical jurisdiction) adopt the challenged

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[1] Michael S. Knoll and Ruth Mason, "Why the Supreme Court Should Grant Certiorari in *Steiner v. Utah*," *Tax Notes State*, Feb. 3, 2020, p. 377.

[2] 449 P.3d 189 (Utah 2019).

[3] *Steiner v. Utah State Tax Commission*, 2020 WL 871753 (Mem).

[4] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

[5] *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S.___, 135 S. Ct. 1787 (2015).

state's tax system. The court then asks — under these conditions of hypothetical harmonization — if cross-border commerce would be taxed more heavily than in-state commerce. If cross-border commerce is taxed more heavily, then the tax discriminates, and it will almost always be struck down.

Despite the Utah Supreme Court's protestations to the contrary, it is straightforward to apply the internal consistency test to Utah's system of cross-border taxation.[6] Utah imposes a flat income tax of 5 percent on both the worldwide income of residents and the Utah income of nonresidents, including residents of other countries.[7] Although Utah provides its residents with credits for source taxes assessed by other U.S. states,[8] it does not credit source taxes assessed in other countries.[9]

As we noted in our prior article, when we apply the internal consistency test to Utah's tax regime for taxing foreign income, we assume that all subnational taxing jurisdictions adopt the Utah regime. Thus, assume a Canadian province, say Ontario, adopts the Utah tax system.[10] Ontario would tax Ontario residents at 5 percent on their worldwide income, and it would tax nonresidents at 5 percent on their income earned in Ontario. Like Utah, Ontario would credit taxes assessed by fellow provinces, but not taxes assessed abroad. Hence, residents of Utah would be taxed at 5 percent on their income earned in Utah and at 10 percent on their income earned in Ontario. Similarly, residents of Ontario would be taxed at 5 percent on their income earned in Ontario and at 10 percent on their income earned in Utah. Accordingly, because cross-border income is taxed more heavily (10 percent) than income earned in the residence jurisdiction (5 percent), the Utah tax is internally inconsistent regarding foreign income. Thus, the Utah tax is discriminatory, and the Utah Supreme Court should have struck it down. Table 1 illustrates the result.

Table 1: Utah's Tax Treatment of Income Earned Abroad Is Internally Inconsistent

		Residence	
		Utah	Ontario
Source	Utah	5%	10%
	Ontario	10%	5%

In sum, the Utah tax regime is internally inconsistent and thus discriminates between in-state and foreign commerce. It therefore violates the commerce clause and should be struck down, unless the state can justify its discrimination, which it has not tried to do. Accordingly, to comply with the U.S. Constitution, Utah must amend its tax law.

Designing a Constitutional State Tax of Foreign Income

In this part, we consider how Utah could revise its tax treatment of foreign income to make it internally consistent, and therefore compliant with the dormant commerce clause. Utah has available to it a wide variety of options for curing the constitutional infirmity in its tax regime, and they fall into three major patterns: apportionment, rate recalibration, and tax credits. We present examples from all three groups that would satisfy the internal consistency test.

Apportionment

One way that Utah could satisfy the internal consistency test would be by moving away from using separate accounting and arm's-length pricing and toward adopting a system that apportioned income across jurisdictions. At one point in the proceedings, the Steiners proposed a

[6] The Utah Tax Court applied the internal consistency test to the facts in *Steiner* quickly, correctly, and with no fuss. *Steiner v. Utah State Tax Commission*, No. 170901774, at 6-7 (Utah Dist. Ct. Jan. 30, 2018).

[7] The Utah statutory income tax rate is a flat 4.95 percent; from 2008 through 2017, it was a flat 5 percent. Official Utah Income Tax Information. Throughout this article, we use a 5 percent rate for simplicity.

[8] The credit is available under Utah Code section 59-10-1003. This credit makes the Utah regime internally consistent regarding interstate income. The Utah regime is only internally inconsistent in its treatment of foreign income.

[9] Utah Code section 59-10-115 allows "an adjustment to adjusted gross income of a resident or nonresident individual [who] would otherwise . . . suffer a double tax detriment under this part," but the Utah tax administration denied the Steiners equitable relief.

[10] Under the Canada-U.S. Tax Treaty, which took effect in 1984, the U.S. taxes covered by the treaty are the federal income tax and some excise taxes on private foundations, and in limited circumstances Social Security taxes. State taxes are not covered. Similarly, in Canada, only Canadian federal taxes are covered. Any taxes imposed on behalf of Canada's subnational governments are not covered. Canada-U.S. Tax Treaty, Article II (1984).

hybrid tax system that would combine both separate accounting and apportionment. The Steiners proposed that Utah apportion their foreign income among the U.S. states in the same manner that Utah apportions corporate income among the states, and tax only that portion allocated thereby to Utah.[11] Under the Steiners' proposal, Utah would continue to use separate accounting to allocate to itself Utahns' Utah-source income and the Utah-source income of foreign residents. The state would then add to income a share of their foreign income determined by calculating a weighted average of their property, payroll, and sales in Utah as compared to their property, payroll, and sales in the United States. This approach obviously fails internal consistency because under hypothetical harmonization, foreign income would be taxed both where it is earned and where the owner resides, whereas there would be only one level of tax when income was earned in the country where the owner resides.[12] Thus, the Steiners' proposed apportionment system could not save Utah's tax system.

In contrast with the Steiners' apportionment proposal, there are two apportionment methods that Utah could adopt that would satisfy the internal consistency test without having to change its tax rates. These methods are:

- Option 1. Domestic apportionment. Utah could apportion only domestic income across the states.
- Option 2. Worldwide apportionment. Utah could apportion worldwide income across the globe.

Option 1: Domestic Apportionment

Although the Steiners' suggestion is similar to the method that Utah (and many other states) uses to apportion corporate income for tax purposes, their proposal is not internally consistent because it assigns all domestic income to domestic jurisdictions and also apportions all foreign income among domestic jurisdictions. In contrast, a tax system that apportioned domestic income among the 50 states and exempted foreign income from U.S. taxation would be internally consistent. If universalized, such a system would tax all income only in the country where it was earned. Although such a system would be constitutional, all foreign income earned by Utahns would be excluded from the Utah tax base.[13]

Option 2: Worldwide Apportionment

The Steiners' suggestion also bears some resemblance to California's worldwide taxation of unitary businesses that the Supreme Court twice upheld,[14] but which California has since retreated from in the face of heavy foreign pressure.[15] The two methods, however, are not equivalent. Under the California method approved by the Court, the state first calculated a unitary taxpayer's worldwide income and then apportioned that income to California using a weighted average of the worldwide apportionment factors (property, payroll, and sales).

The weighted average compares a taxpayer's California presence to its worldwide presence. Such a system is internally consistent because under hypothetical harmonization all income is taxed once and only once. The unitary income was divided among jurisdictions according to the relative presence in each jurisdiction of the unitary business's factors of production. Under this approach, Utah would be able to tax its proportional share of the foreign income of Utahns, but Utah would also have to exempt the share of Utah income of residents that was allocable elsewhere under the formula.[16]

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[11] Utah apportions corporate income by calculating a corporation's U.S. income (its foreign income is excluded) and then apportioning income to Utah by calculating a weighted average of the apportionment factors (property, payroll, and sales in Utah divided by total U.S. property, payroll, and sales) and multiplying the corporation's U.S. income by the weighted average of its Utah apportionment factors. This method compares a taxpayer's Utah presence to its U.S. presence.

[12] The Steiners' proposal would still fail internal consistency if their foreign income was apportioned using worldwide rather than U.S.-factor shares. In that case, some cross-border income would be taxed twice, whereas domestic income would still be taxed once.

[13] Of course, such a system would mean that Utah would forgo its practice of taxing Utahns' income earned in other states and granting Utahns a credit for taxes paid to the other states.

[14] *See Barclays Bank v. Franchise Tax Board of California*, 512 U.S. 298 (1994); and *Container Corp.*, 463 U.S. 159.

[15] *See Barclays Bank*, 512 U.S. at 306 (noting that California and other states that required worldwide reporting had amended their combined reporting regimes to allow election of a "water's edge" treatment that confines apportionment to U.S.-source income).

[16] As with domestic apportionment, such a system would mean that Utah would forgo taxing Utahns' income earned in other states and granting a credit for taxes paid to other states.

Rate Recalibration

As described above, Utah could satisfy the internal consistency test and maintain its rate structure without granting tax credits by adopting either domestic or worldwide apportionment. Such an approach, however, would end Utah's practice of assigning income to a jurisdiction using separate accounting and the arm's-length principle. Because switching to apportionment would constitute a fundamental change in its tax system for individuals, we next describe the two approaches available to Utah that maintain separate accounting.

Utah could reconfigure the rates of its tax system so that under internal consistency, the tax on Utah-source income earned by Utahns (that is, domestic tax) was no higher than the combination of the tax on Utahns' economic activities abroad (outbound tax) plus the tax on foreign residents' economic activities in Utah (inbound tax). Its goal, in amending its rate structure to comply with the dormant foreign commerce clause, would be to satisfy the following tax rate condition:

$$T_d \geq T_o + T_i - (T_o \; x \; T_i)$$

T_d, or the domestic tax, is Utah's tax on Utahns' in-state income; T_o, or the outbound tax is Utah's tax on Utahns' foreign-source income, and T_i, or the inbound tax, is Utah's tax rate on nonresident aliens' in-state income.[17]

Although there are infinitely many combinations of these three rates that would satisfy internal consistency, we note the following three options because each involves changing only one of the three tax rates as compared with Utah's current system.

- Option 3. Eliminate the Outbound Tax. Utah could lower the outbound tax to zero. In other words, it could exclude Utah residents' foreign-source income.
- Option 4. Eliminate the Inbound Tax. Utah could also eliminate the inbound tax on foreign residents who earn income in the state. Utah could continue to tax the foreign income of residents, along with the domestic income of residents, but forgo taxing the in-state income of foreign residents.
- Option 5. Increase the Domestic Tax Rate. Utah could alternatively increase the tax rate on the in-state income of Utah residents to eliminate the current regime's excess burden on cross-border commerce.

Option 3: Eliminate the Outbound Tax

The simplest approach toward foreign income and the most straightforward to examine is an exclusion of Utahns' foreign-source income. Such a cross-border tax system is sometimes called territorial taxation or exemption, and, as can be readily seen, it is internally consistent. If Utah were to exclude residents' foreign income, and if Ontario were assumed to adopt the same tax system as Utah (as the internal consistency test calls for), then residents of Utah and residents of Ontario would both be taxed at 5 percent wherever they earn income. No one would be taxed at home on income earned in the other country. Because the total tax rate would be 5 percent regardless of where one earned income, such a Utah tax would be internally consistent. Moreover, although Utah's tax treatment of income earned by Utah residents in other U.S. states would differ from its tax treatment of income earned by Utah residents in foreign countries, there should be no tension between them because they both work with Utah having a tax rate of 5 percent on Utahns' in-state income.[18]

Option 4: Eliminate the Inbound Tax

Alternatively, Utah could eliminate its discrimination against foreign commerce without changing its tax treatment of Utahns' domestic or foreign income if Utah were willing to forgo taxing the Utah income of foreign residents. Such a tax is internally consistent because in the hypothetical harmonization Ontario would not tax Utahns' Ontario income and hence taxation of foreign income would only occur in the state of residence and at the same rate as for in-state income. Moreover, such a tax

[17] *See* Knoll and Mason, "The Economic Foundations of the Dormant Commerce Clause," 103 *Va. L. Rev.* 309, 323 (2017); and Ryan Lirette and Alan D. Viard, "Putting the Commerce Back in the Dormant Commerce Clause: State Taxes, State Subsidies, and Commerce Neutrality," 24 *J. of L. & Pol'y* 467, 483 (2016).

[18] This would be so if Utah retained the tax credit available under current law for source taxes assessed by other U.S. states.

system, although different from the treatment of income earned in other U.S. states, can exist alongside a full credit for taxes paid to other U.S. states without creating tension because both systems are internally consistent with the same tax rate on Utahns' in-state income.

Option 5: Increase the Domestic Tax Rate

Every taxpayer bringing a dormant commerce clause challenge against a state tax hopes that the remedy will be a refund of tax. But discrimination can be cured not only by refunding taxes to the group that experienced discrimination, but also by increasing the taxes of the favored group. As the Supreme Court observed in *Wynne*:

> Whenever government impermissibly treats like cases differently, it can cure the violation by either "leveling up" or "leveling down." Whenever a State impermissibly taxes interstate commerce at a higher rate than intrastate commerce, that infirmity could be cured by lowering the higher rate, raising the lower rate, or a combination of the two.[19]

Utah can make its tax system internally consistent not only by lowering taxes, but also by raising taxes that residents pay on in-state income. Specifically, Utah could increase the tax rate on the in-state income of Utahns up to the sum of the tax rate on nonresidents' Utah income and residents' out-of-state income.[20] For example, if Utah were to increase the tax rate on residents' domestic income from 5 percent to roughly 10 percent,[21] Utah could retain its 5 percent tax rate on Utahns' foreign income and its 5 percent tax rate on the Utah income of nonresidents. If such a tax were universalized, then both foreign and in-state income would be taxed at 10 percent. Accordingly, such a tax system is internally consistent in its treatment of foreign and in-state income.

Such an approach, however, would impose a higher tax on Utahns' in-state income than is necessary to achieve internal consistency regarding *interstate* commerce. As a result, such a tax would discourage Utah residents from earning income in Utah as compared with residents from other U.S. states.[22] Such reverse discrimination is not unconstitutional, but it is not common, either, as it is politically unpalatable.

Thus, there are several ways that Utah could revise its tax laws without granting a tax credit on foreign income so that its treatment of foreign income was internally consistent. We next examine the different ways that Utah could use tax credits to achieve internal consistency.

Tax Credits

The final class of tax systems that satisfies internal consistency is worldwide taxation with a limited (or more generous) tax credit. A limited tax credit is a credit offered by a residence state for taxes paid to other jurisdictions on income earned in other jurisdictions up to, but not beyond, the taxpayer's tentative tax liability to the residence state on the same income.[23] Income tax systems with a limited tax credit (but no more) are fairly common. There are at least two ways that Utah could grant tax credits to Utah residents with foreign income that would arguably be consistent with the internal consistency test:

- Option 6. Mirror image credit. States (subnational political divisions) could credit all taxes paid to foreign subnational political entities but not taxes paid to foreign national governments.
- Option 7. Residual credit. States could credit foreign taxes paid (whether paid to national governments or political subdivisions) to the extent such taxes are

[19] *Wynne*, 135 S. Ct. at 1806.

[20] *See* Knoll and Mason, *supra* note 18, at 341.

[21] If the Utah tax rate on residents' out-of-state and on nonresidents' in-state income was 5 percent and Utah taxed its residents on their worldwide income without allowing a deduction for taxes paid to other states, then the tax rate on residents' in-state income would have to rise to 10 percent to achieve internal consistency. If, however, Utah allowed residents a deduction for the taxes paid on foreign income, then the in-state rate would have to rise to only 9.75 percent.

[22] Such a tax would also provide Utahns with a tax-induced advantage over nonresidents in earning income in other U.S. states.

[23] No state offers an unlimited tax credit. Because such a system has the potential to lead to massive refunds, at most states offer a limited credit that would zero out the taxpayer's liability to the residence state.

not credited by the U.S. federal government.

Option 6: Mirror Image Credit

Utah could follow the lead of some states and municipalities after *Wynne* and adopt a mirror image tax system for the credit. Under this approach, Utah would credit taxes paid abroad if, but only if, those taxes are assessed at a subnational level similar to the level of the U.S. states. Such a system, which is how Utah taxes income earned by its residents in other U.S. states, would be internally consistent. Such a credit, however, would overcompensate Utah residents whenever a resident's federal credit had already effectively compensated them for subnational foreign taxes.[24]

This possibility of a double credit might lead Utah to restrict access to the credit. Utah might do so directly by prohibiting double crediting of subnational taxes. Such techniques implicate the external consistency strand of tax discrimination, which requires a reasonable connection between the income the state seeks to tax and the income-generating activities conducted in state.[25]

Option 7: Residual Credit

An alternative approach to the foreign tax credit would start with the recognition that a dollar of tax is a dollar of tax whether it is imposed at the national or subnational level. Thus, it makes sense to provide a state credit for taxes paid to foreign national and subnational governments if those taxes have not already been credited by the U.S. federal government. Such an approach would allow a state credit once the foreign national-plus-subnational tax rate exceeded the federal rate. The Utah credit could be limited by the federal tax rate plus the Utah tax rate on in-state income. Such an approach is a holistic approach to internal consistency; it compares the full tax liability.[26]

Conclusion

Although the Utah tax system is internally inconsistent and hence discriminates against foreign commerce in violation of the dormant foreign commerce clause, there are several alternative means readily available to Utah to modify its tax regime to eliminate that discrimination and meet its constitutional obligations. ■

[24]Utah residents would be overcompensated whenever foreign taxes were less than federal taxes on the same income.

[25]*Container Corp.*, 463 U.S. at 169.

[26]For some taxpayers in some circumstances, this calculation can be complex.