Iowa General Assembly

2015 Legal Updates

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Purpose. *Legal update briefings are prepared by the nonpartisan Legal Services Division of the Legislative Services Agency. A legal update briefing is intended to inform legislators, legislative staff, and other persons interested in legislative matters of recent court decisions, Attorney General Opinions, regulatory actions, federal actions, and other occurrences of a legal nature that may be pertinent to the General Assembly's consideration of a topic. Although a briefing may identify issues for consideration by the General Assembly, a briefing should not be interpreted as advocating any particular course of action.*

STATE INCOME TAXATION OF RESIDENT INDIVIDUALS

Filed by the United States Supreme Court
May 18, 2015

Comptroller of the Treasury of Maryland v. Wynne

No. 13-485, 135 S.Ct. 1787 (2015)

http://www.supremecourt.gov/opinions/14pdf/13-485_o7jp.pdf

Background Facts and Prior Proceedings. Maryland, like many other states (including Iowa), taxes all the income its residents earn both inside and outside the state. Maryland's resident income tax scheme has two components: a "state" income tax and a "county" income tax. The "state" income tax consists of a set of graduated rates, and the "county" income tax consists of one capped rate set by the county. Both of these taxes are collected by the Maryland State Comptroller of the Treasury (Comptroller). Maryland residents who pay income taxes to another jurisdiction for income earned in that jurisdiction are allowed a credit for those taxes against the "state" tax, but not against the "county" tax.

Maryland also taxes nonresidents on the income they earn from sources within Maryland, and, in lieu of the resident "county" tax, imposes a "special nonresident" tax equal to the lowest "county" tax rate.

In 2006, two Maryland residents, Brian and Karen Wynne (Wynnes), owned stock in a Subchapter S corporation that earned income in numerous states. By operation of federal and state law, this income passed through the corporation to the Wynnes and was taxable to them on an individual basis. The Wynnes owed tax to several other states as a result of this corporation's business activity. On their 2006 Maryland income tax return, the Wynnes claimed an income tax credit for the income taxes paid to the other states. Pursuant to Maryland law, the Comptroller allowed this credit against the "state" tax, but not against the "county" tax, and assessed a tax deficiency against the Wynnes.

The Maryland Tax Court affirmed the finding of the Comptroller, but the Circuit Court for Howard County reversed on the ground that the tax scheme violated the Commerce Clause of the Federal Constitution. The Court of Appeals of Maryland affirmed the judgment of the Circuit Court. The United States Supreme Court (Court) granted certiorari.

Issue. Whether taxing all the income of a resident without offering a credit for taxes paid on income earned in other states violates the Commerce Clause of the Federal Constitution.

Holding. Maryland's individual income tax scheme violates the dormant Commerce Clause of the Federal Constitution.

Dormant Commerce Clause. The Commerce Clause of the Federal Constitution grants Congress the power to regulate commerce among the several states. The Court has consistently held that this power also contains a negative command, referred to as the "dormant Commerce Clause," that prohibits states from discriminating against, or unduly burdening, interstate commerce in the absence of Congressional approval. The Court has developed a four-part test to determine the validity of state tax laws under the dormant Commerce Clause: the laws must be applied to an activity with a substantial nexus in the state, must be fairly apportioned, must not discriminate against interstate commerce, and must be fairly related to the services provided by the state.

Majority Opinion by Justice Alito. The majority concluded that Maryland's individual income tax scheme discriminated against interstate commerce. The Court relied principally on three prior Court cases (involving the taxation of domestic corporation income) that struck down tax schemes that resulted in double taxation of interstate income and that discriminated in favor of intrastate economic activity. The Court also analyzed Maryland's income tax scheme against the so-called "internal consistency test." This test, created by the Court to analyze the constitutionality of state tax laws under the Commerce Clause, assumes that every state has adopted the tax law at issue thereby allowing the Court to evaluate whether its uniform application causes interstate commerce to be taxed at a higher rate than intrastate commerce. It helps the Court differentiate between tax laws that are inherently discriminatory against interstate commerce (typically unconstitutional), and tax laws that could create double taxation of income, or disparate incentives to engage in interstate commerce, only because of the interaction between two different but nondiscriminatory tax laws (typically constitutional). When analyzed in this context, the Court determined that Maryland's individual income tax scheme fails the test. A Maryland resident earning income solely in another state (State B) would be subject to Maryland's "county" tax on that income by virtue of being a Maryland resident, but would also be subject to the "special nonresident tax" in State B on the same income. A different Maryland resident earning income solely in Maryland would only be subject to Maryland's "county" tax. Maryland's tax scheme causes individuals to pay more total income tax solely because income is earned from interstate activity, and subjects interstate income to the risk of double taxation. The Court likened this tax scheme to state tariffs, which, it stated, are "so patently unconstitutional that our cases reveal not a single attempt by any state to enact one."

The Court stated that Maryland could remedy its faulty tax scheme by offering a credit against the "county" tax for income taxes paid to other states. The Court also noted the possibility that Maryland could comply with the dormant Commerce Clause in other ways, but it declined to speculate further.

Dissent by Justice Ginsburg. The principal dissent, filed by Justice Ginsburg and joined by Justices Scalia and Kagan, argued that the majority's holding violated the Court's prior decisions and its long-held principle that a state may tax all the income of its residents, even income earned outside the state, regardless of whether another state exercises its taxing authority on that income. The principal dissent reasoned that differing treatment by states of residents and nonresidents is warranted because more services and benefits are provided to residents, therefore more may be demanded of them, regardless of any obligations they may have to other states. Moreover, residents, through the political process, have the ability to ensure that their state's power to tax their income is not abused. The principal dissent noted the Court's past observation that "it is not a purpose of the Commerce Clause to protect state residents from their own state taxes."

The principal dissent criticized the cases relied on by the majority because they involved taxes on gross receipts other than net income. The principal dissent noted that the Court historically distinguished between the two because gross receipts taxes are more burdensome than net income taxes, and argued that the Court has not, as the majority contended, already rejected this formal distinction.

The principal dissent also criticized the majority's use of the internal consistency test, noting that the Court has not struck down a state tax for failing the test in nearly 30 years, and has even upheld state taxes that fail the test. The principal dissent also considered the test to be flawed in its application, arguing that the internal inconsistency of Maryland's tax scheme could be remedied by eliminating the "special nonresident" tax, a measure that would not grant the Wynnes relief from the double taxation of their income.

Finally, the principal dissent rejected the majority's claim that Maryland's tax scheme operated as a tariff, reasoning that it actually taxes residents' in-state and out-of-state income at the same rate, and therefore did not discriminate against out-of-state income.

Dissents by Justices Scalia and Thomas. Justices Scalia and Thomas filed separate dissents in which they each argued that the Commerce Clause does not contain a dormant Commerce Clause. Chief among the reasons is that the text of the Commerce Clause does not contain any language prohibiting state laws that burden commerce. In further support of their position, the Justices noted the lack of discussion from the framers about such a prohibition on the states during the ratification of the Constitution, and the fact that, during such ratification period, states made regulations that burdened interstate commerce and imposed income taxes with no credit for other income taxes paid.

Justice Scalia further opined that the dormant Commerce Clause lacks a governing principle, is unstable, has led the Court to create a variety of ad hoc tests and exceptions, and is incompatible with the judicial role because it requires the Court to balance the needs of commerce against the needs of state governments. He stated that such balancing is a task for legislators, not judges.

Impact on Iowa. It remains to be seen whether this decision will have an impact on Iowa. Iowa's individual income tax scheme is similar in many respects to the Maryland tax scheme struck down by the Court. Iowa imposes an income tax on its residents' entire income, but provides a credit for "the amount of income tax paid to another state or foreign county" on "income derived outside of Iowa." Iowa's local governments have the option to impose (without a credit for other state or foreign taxes paid) certain surtaxes on the Iowa income tax of residents living within their boundaries. However, these local government surtaxes are not imposed on nonresidents, thus Iowa has nothing similar to the "special nonresident" tax imposed in Maryland. The principal dissent opined that Maryland's tax scheme would be constitutional if (like Iowa) it did not include a "special nonresident" tax. Nevertheless, this case certainly imposes additional constitutional constraints on state income taxation, and the allowance to Iowa residents of tax credits for taxes paid in other states can no longer be considered purely a matter of public policy.

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