Tax Watch

BROWNEDWARDS
certified public accountants

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MULTISTATE TAXATION: U. S. SUPREME COURT STRIKES DOWN DOUBLE-TAX STRUCTURE

Today many taxpayers earn income in states other than the ones where they reside, which can lead to tax liability in multiple jurisdictions. With laws differing from state to state, determining how much tax is owed in each jurisdiction can be complicated. In a highly anticipated decision, the U.S. Supreme Court addressed how one state taxes its residents' out-of-state income.

In *Comptroller of the State of Maryland v. Wynne, the* Court struck down a Maryland tax structure that it found unconstitutionally subjected state residents to double taxation on income earned in other states. Although the Court's 5-4 ruling, which included four dissenting opinions, addressed only Maryland law, it could ultimately have an impact on taxpayers outside of Maryland whose state and local governments have similar "double-dipping" taxation schemes.

The path to the Supreme Court

Maryland imposes personal tax on state residents in the form of a "state" income tax and a "county" income tax. Residents who pay income tax in another jurisdiction for income earned in that jurisdiction are allowed a credit against the state tax but not the county tax. As a result, part of the income earned by a Maryland resident outside of the state's borders may effectively be taxed twice. Further, nonresidents who earn income from Maryland sources must pay the state income tax, and nonresidents not subject to the county tax must pay a "special nonresident tax" in lieu of the county tax.

A married couple who were Maryland residents earned income from an S corporation that earned income in several states. They claimed an income tax credit on their 2006 state income tax return for taxes paid to 39 other states. The state Comptroller of the Treasury allowed the credit against their state income tax but not against their county income tax, resulting in the assessment of a tax deficiency.

The assessment was affirmed by the Hearings and Appeals Section of the Comptroller's Office and by the Maryland Tax Court, but the Circuit Court for Howard County reversed on the ground that Maryland's tax system violated the Commerce Clause of the U.S. Constitution. The Court of Appeals of Maryland affirmed, and the case proceeded to the U.S. Supreme Court.

The Court's reasoning

On May 18, 2015, the Supreme Court affirmed the Maryland Court of Appeal's ruling in favor of the taxpayers. In doing so, it found that Maryland's failure to allow a credit against the county tax for taxes paid to other states violates the "dormant" Commerce Clause.

The Commerce Clause grants Congress the power to "regulate Commerce . . . among the several States." The Supreme Court has long held that the clause's language contains a feature known as the "dormant Commerce Clause," which prohibits states from discriminating between transactions on the basis of some interstate element. In other words, a state can't more heavily tax a transaction that crosses state lines than one that occurs

entirely within the state, nor can it subject interstate commerce to "multiple taxation."

Justice Samuel Alito, who wrote the majority opinion, concluded that, by taxing residents on all of their income without a credit for out-of-state taxes *and* taxing nonresidents on their income earned in the state, Maryland's tax structure was inherently discriminatory. The structure, therefore, failed the "internal consistency" test and was invalid.

In their dissenting opinions, Justices Antonin Scalia and Clarence Thomas reiterated their previous arguments that the so-called dormant Commerce Clause doesn't exist. They also dismissed Justice Alito's use of the internal consistency test, which the two justices believe was dismantled by a prior decision.

Taxation of corporations vs. individuals

The Supreme Court also pointed out that it has long held that states can't subject corporate income to higher taxes on dollars earned in interstate commerce. It found no reason not to provide similar protections to income earned by individuals, rejecting Maryland's argument that individuals reap the benefits of local roads, police and fire protection, public schools and health benefits more than corporations do.

The Court observed that corporations use local roads to haul supplies and goods, call on local police and fire departments to protect their facilities, and rely on schools to educate prospective employees. Government services and the availability of good schools can aid businesses in attracting and retaining employees. Thus, the Court stated, "disparate treatment of corporate and personal income cannot be justified based on the state services enjoyed by these two groups of taxpayers."

Far-reaching implications?

The Court's ruling obviously will have a dramatic and immediate impact in Maryland, but it could also cause waves in other jurisdictions. For example, other states that may be affected include North Carolina, Ohio, Pennsylvania, Tennessee and Wisconsin. Several cities also may be affected, such as Detroit, Kansas City, New York, St. Louis and Wilmington, Del. The decision may ultimately lead to tax code amendments and the issuance of refunds. And other jurisdictions are now unlikely to try to double-dip on out-of-state income as Maryland did.

This case illustrates just one of the many complexities of multistate taxation. If you have questions about how the Supreme Court's ruling may affect you — or other questions about multistate taxation — please give us a call.

State & Local Tax Updates

Tennessee Revenue Modernization Act

On May 20, 2015, Governor Bill Hasiam signed the Revenue Modernization Act (The Act). The Act expands the definition of nexus, changes sourcing rules for franchise and excise tax purposes, places greater weight on the sales factor for franchise and excise tax purposes and makes other changes.

Please contact your Brown Edwards tax advisor for more details.