

# State Resident Tax Credits after the Wynne Decision



*Presented by*  
**Timothy P. Noonan, J.D.**

# Introduction



- Constitutional Law Basics
- Resident Credit Concepts
- *Wynne*: From Start to Finish
- Deconstructing the Court's Decision
- Answering Questions

# Legal and Factual Background

# Constitutional Law

## *The Basics*

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- Article I, of 8, clause 3 of U.S. Constitution:  
The Commerce Clause
  - Grants Congress power “to regulate commerce ... among the several states”
  - Initial idea
    - Avoid “Balkanization” that plagued relations among Colonies and under Articles of Confederation

# Constitutional Law

## *The Basics*

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- The “Negative” or “Dormant” Commerce Clause
  - Though framed as positive grant of power to Congress, Court has “consistently held this language to contain a further, negative command”
  - “Prohibiting certain state taxation even when Congress has failed to legislate on the subject” (*Jefferson Lines*, 1995)

# Constitutional Law

## *The Basics*

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- This “negative” aspect has been disputed
  - In *Wynne*, Justice Scalia called it a “judicial fraud!”
  - Also, he said it “has deep roots, like many weeds”
  - He also called it the “Synthetic Commerce Clause” and the “Imaginary Commerce Clause”
- But it’s not going anywhere
  - MD didn’t even make the argument!

# The Basics

## *Resident Credits*

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- States generally tax their own residents on all income, regardless of source
  - Residents are taxed on one thing
- Nonresidents only taxed on income from in-state sources
  - Wages for in-state services
  - Income from in-state business
  - Income from in-state property

# The Basics

## *Resident Credits*

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### Resident Credits

- State allows its resident a dollar-for-dollar credit for taxes paid to other states
- Can't exceed tax due in home state
  - i.e., CT resident at 6.5% tax rate can't get full resident credit for taxes paid to NY at 8.82%
- Often only allowed for source-based taxes in nonresident state



# Resident Credit Example

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- Mike lives in CT, works in NY and makes \$100k/yr

NYS tax - \$8,800

CT tax - \$6,500

less - \$6,500 (credit for NY tax, maxed out at \$6,500)

\$0 Total CT tax bill

- Monica lives in CT, works in PA and makes \$100k/yr

PA tax - \$5,000

CT tax - \$6,500

less - \$5,000 (credit for PA tax)

\$1,500 Total CT tax bill

# The Basics

## *Resident Credits*

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### Important Limitations

#### 1. Different sourcing rules

- Example
  - CT will only give credit for taxes paid to other states on income from sources in that state – determined under CT’s sourcing rules!
- Convenience Rule Problem
- See attached “Heads they Win, Tails You Lose” Article

#### 2. “Unearned” or “Non-Source” Income

- If two states impose tax on a taxpayer’s intangible income (not sourceable anywhere), usually no resident credits
- CT/NY dual residency
  - Prime example
- New Jersey is much nicer!



# Polling Question #1



Do your clients think *Wynne* is a big deal?

- Yes, I've received many questions from clients
- No, a few questions, no more than any other tax case that's been in the news
- Not at all, nobody is bugging me about it

# Wynne Background

## *MD Rules*

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- MD residents (like NY residents) pay tax on their worldwide income
- MD personal income tax has two components
  1. State, and
  2. County
- Nonresidents only pay tax on sourced income, but they pay BOTH the state and county tax
  - Called “special nonresident tax”
- Residents only allowed credit against state portion of tax

# *Wynne* Background *Facts*

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- MD residents who held stock in an S corp that operated and filed returns in 39 other states
- Reported flow-through income from the S corp on MD income tax returns
- Claimed resident tax credit (against both the state and county components) for taxes paid to other states
- The MD State Comptroller disallowed credit against county component

# Wynne Background

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- So Wynnes pay tax to MD as residents (say 6%) and rate includes a county component (say 1%)
- They also pay tax in CA at 13% rate
- MD will allow an offset for CA taxes paid, but only against the 6% state tax; 1% county tax can NEVER be offset
- Constitutional dispute
  - Is that legitimate?
  - Can a state tax its residents on all income and NOT provide full credit for taxes paid to other states?

# Wynne Background

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## Stated another way ...

- Are resident credits a creature of legislative grace and good tax policy?

— or —

- Are resident credits constitutionally required?

# *Wynne* Tax Court Decision

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- Affirmed the Hearings and Appeals Section's ruling which held that the no credit was allowed against the county component of MD's income tax
- Tax Court reversed by Circuit Court for Howard County, which held that MD's tax scheme violated the Commerce Clause



# Wynne

## MD Court of Appeals Decision

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- MD's high court affirmed the Circuit Court
- Evaluated MD's tax under *Complete Auto's* four-part test
  1. Substantial nexus with taxing state
  2. Fairly apportioned
  3. Doesn't discriminate against interstate commerce
  4. Fairly related to services provided by the state
- Held that MD's tax violated #2 and #3

# Attendance Validation #1



Keep this form handy!  
We'll have two more attendance validation items for you to write down later in today's webinar.

Please locate your  
Attendance Validation Form

(it should be the 5<sup>th</sup> page in your Handout Materials)

**dormant**

**REMINDER!**

You can e-mail your questions during today's seminar to be passed along to our presenter for response during the Q&A session -



Send your questions to

***seminars@wolterskluwer.com***

# Wynne

## *Breaking Down the Supreme Court's Decision*



# Polling Question #2



The Supreme Court takes on tax cases?

- All the time
- As much as other cases
- Very rarely

# On to the Supreme Court?

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## ● Petition for *Certiorari*

- Why would the Court take the case?
- Renewed interest in taxes?



# Supreme Court Decision

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- See Decision/Articles in Appendix
- Majority: 5 Justices
  - Alito, Roberts, Kennedy, Sotomayer, Breyer
- Dissent: 4 Justices
  - Ginsberg, Scalia, Kagan
  - Thomas – separate dissent

# On to the Supreme Court

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During Oral argument, Chief Justice John Roberts observed that

*“If each State did what we’re talking about, people who work in one State and live in another would pay higher taxes overall than people who live within one State and work in the same State.”*





# The Internal Consistency Test

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- Justice Roberts was talking about the “Internal Consistency Test”
  - The Commerce Clause requires that taxes on interstate commerce be nondiscriminatory and fairly apportioned
- This test is designed to allow us to distinguish between
  - i. A tax structure that is inherently discriminatory (bad); and
  - ii. One that might result in double taxes only as a result of two nondiscriminatory state schemes (OK)
- Past cases may have suggested that the Commerce Clause was N/A to individual income taxes; the Court laid that to waste



# The Internal Consistency Test

*The test: whether interstate and intrastate commerce would be taxed equally if every state were to adopt the precise tax scheme at issue*

- State A imposes a 1.25% tax on all residents, regardless of where earned
- State A also imposes a tax on nonresidents' source income at 1.25%
- No resident credits
- April and Bob live next door to each other in State A; Bob's business located in State B; April's is all in State A
- To apply the I/C test, we have to assume all states have the State A scheme
- State A fails the test!!

|                  | April | Bob   |
|------------------|-------|-------|
| State A Tax      | 1.25% | 1.25% |
| Hypo State B Tax | 0     | 1.25% |
| Total Bill       | 1.25% | 2.5%  |

# Alito Point-Counterpoint

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## Dissent Point

- The “difference between taxes on net income and taxes on gross receipts from interstate commerce warrant different results”

## Alito Counterpoint

- “We see no reason why the distinction between gross receipts and net income should matter” and in any event “our cases rejected this formal distinction some time ago”

# Alito Point-Counterpoint

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## Dissent Point

- The dormant Commerce Clause does not apply equally to corps and individuals since individuals receive different (more) services and they can vote

## Alito Counterpoint

- Corps also receive state services and a law's constitutionality doesn't turn on whether the challenger can vote

# Alito Point-Counterpoint

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## Dissent Point

- States have sovereign power to tax 100% of residents' worldwide income and the Commerce Clause doesn't limit a state's ability to tax its residents' income, regardless of where earned

## Alito Counterpoint

- Just because a state has jurisdiction to tax (under the 14<sup>th</sup> Amendment's Due Process Clause) doesn't preclude a finding that the tax violates the Commerce Clause

# Alito Point-Counterpoint

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## Dissent Point

- Because of the credit, MD actually gets less tax revenue from residents engaged in interstate commerce

## Alito Counterpoint

- The focus is on the total tax burden on interstate commerce; not whether MD gets more or less tax from a particular taxpayer – it's a substance over form inquiry

# Alito Point-Counterpoint

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## Dissent Point

- MD could cure the internal inconsistency by eliminating the tax on nonresidents

## Alito Counterpoint

- The existence of a remedy doesn't render the tax constitutional

# Alito Point-Counterpoint

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## Dissent Point

- The dormant Commerce Clause is “a judicial fraud”

## Alito Counterpoint

- The doctrine was first applied by Chief Justice John Marshall’s decision in *Gibbons v. Ogden* (1824) and has since been applied in dozens of SCOTUS opinions, joined by dozens of Justices

# The Aftermath of *Wynne*

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- Commerce Clause protections extend equally to
  - Taxes based on gross and net income
    - Prior cases generally focused on gross receipts taxes; and
  - Both corporations and individuals
    - Prior cases generally dealt with corporations
- Maryland counties to pay more than \$200 million in refunds
- Consider filing refund claims – in Maryland, and maybe even elsewhere?



# Attendance Validation #2

Time to record our second attendance check item on your Attendance Validation Form

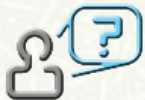
**Commerce Clause**



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# Take a Break!

## *Return in 5 Minutes*

### Featured Upcoming Program:



Timothy P. Noonan, Esq.

### Multistate Taxation of e-Commerce and Internet Transactions

**Tuesday, November 3, 2015**

# Questions, Questions, and More Questions

# Questions

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- ***Are resident credits now constitutionally required?***
  - Per majority, yes
  - But only if states also tax nonresidents
  - Dissenters took a different view, but don't expect this to change



# Questions

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- ***What state resident credit schemes are or could be directly impacted by the decision?***
- **States**
  - Wisconsin, North Carolina, Tennessee, Massachusetts, Iowa
- **Local Jurisdictions**
  - NYC, Philadelphia, Cleveland, Detroit, Kansas City, St. Louis, Wilmington (DE), Indiana's counties

# Questions

Could the MD structure be **cured** in order to pass the Internal Consistency Test by allowing a resident credit?

- State A imposes a 1.25% tax on all residents, regardless of where earned
- State A also imposes a tax on nonresidents' source income at 1.25%
- State A provides resident credit for taxes paid to other states on sourced income**
- April and Bob live next door to each other in State A; Bob's business is located in State B; April's is all in State A

|                  | April | Bob   |
|------------------|-------|-------|
| State A Tax      | 1.25% | 0     |
| Hypo State B Tax | 0     | 1.25% |
| Total Bill       | 1.25% | 1.25% |

# Questions

***Could the MD structure be cured in order to pass the Internal Consistency Test by not having the Counties tax nonresidents?***

- State A imposes a 1.25% tax on all residents, regardless of where earned
- State A does not tax nonresidents***
- No resident credits
- April and Bob live next door to each other in State A; Bob's business is located in State B; April's is all in State A

|                  | April | Bob   |
|------------------|-------|-------|
| State A Tax      | 1.25% | 1.25% |
| Hypo State B Tax | 0     | 0     |
| Total Bill       | 1.25% | 1.25% |

- But is this fairly apportioned - externally consistent?

# The Internal Consistency Test

## *Be Careful*

*Don't get lost in the differences between the rules in two states*

- State A imposes a 1.25% tax on all residents, regardless of where earned
- State A does not tax nonresidents and provides no resident credits (which is internally consistent per previous slide)*
- But assume State B is a *real state*; and it *does* tax nonresidents
- April and Bob live next door to each other in State A; Bob's business is located in State B; April's is all in State A

|                           | April | Bob   |
|---------------------------|-------|-------|
| State A Tax               | 1.25% | 1.25% |
| <i>Actual</i> State B Tax | 0     | 1.25% |
| Total Bill                | 1.25% | 2.5%  |

- This stinks for Bob. And there is double tax. But NOT because State A's scheme fails the test; only because of what State B is doing



# Questions

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## 🌐 *Is all double tax unconstitutional?*

- No — see previous slide
- Double tax OK if the states' tax schemes are internally consistent

# Questions

- ***Must NYS allow resident credit against NYC personal income taxes for source income in other states?***
- CA is typical example, since NYC resident with source income pays 13% to CA and only gets credit against 8% NYS tax
  - No longer can say Commerce Clause n/a to individuals
  - Unlike MD, NYC doesn't tax nonresidents
  - But see slide 39: Fair apportionment?



# Questions

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- *Is NY's Statutory Residency Test (and other dual residency situations) now at risk?*
- Court of Appeals in *Tamagni* upheld rule; declined to apply Commerce Clause analysis, but said that rule was fine anyway even if it did
  - How does the *Wynne* rule, that the Commerce Clause applies to individuals, affect the analysis?
  - Must a credit be provided for taxes paid to other states in all circumstances?
  - Different rule for “non-sourced” income?
  - 1995 NESTOA agreement attempted to remedy (see attached article)

# Questions

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- *Is NY's convenience rule unconstitutional?*
- Court of Appeals in *Zelinsky* upheld rule; applied Commerce Clause analysis and said that rule was fine
  - No question about I-C test; taxpayer conceded the rule passed
  - External consistency was issue
  - But what about reverse-convenience days?

# Attendance Validation #3



Here is the 3<sup>rd</sup> and FINAL attendance validation for today's webinar.

**double taxation**





# Question and Answer Session

You can e-mail your questions to

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*Please limit your questions to only topics discussed during today's presentation.*

# CONCLUSION

# Thank You for Attending Today's Webinar



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# Featured Upcoming Program



Timothy P. Noonan, Esq.

## Multistate Taxation of e-Commerce and Internet Transactions

**Tuesday, November 3, 2015**