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No. 13-485

IN THE

Supreme Court of the United States

MARYLAND STATE COMPTROLLER
OF THE TREASURY,

Petitioner,

v.

BRYAN WYNNE, *et ux.*,

Respondents.

ON WRIT OF CERTIORARI TO THE
MARYLAND COURT OF APPEALS

BRIEF OF MICHAEL S. KNOLL AND RUTH MASON AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTIONS PRESENTED

(1) Does the Maryland "county" income tax violate the dormant Commerce Clause by discouraging cross-border commerce in favor of in-state commerce?

(2) If the Maryland "county" income tax violates the dormant Commerce Clause, does the Constitution require Maryland to fully credit the taxes of other states against its "county" tax?

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BRIEF OF MICHAEL S. KNOLL AND RUTH MASON AS *AMICI CURIAE* IN SUPPORT OF AFFIRMANCE

INTEREST OF *AMICI CURIAE*[1]

Amici are tax professors who, based on their expertise in law and economics, conclude that the Maryland personal income tax regime, specifically the Maryland "county" tax, violates the dormant Commerce Clause by discouraging interstate commerce, but that a credit is not the only possible remedy for the breach.

Michael S. Knoll is Deputy Dean and Theodore Warner Professor, University of Pennsylvania Law School; Professor of Real Estate, The Wharton School; Co-director, Center for Tax Law and Policy, University of Pennsylvania. Much of Professor Knoll's recent research focuses on the connections between taxation and competitiveness.

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1. No counsel for any party authored this brief in whole or in part and no entity or person, aside from *amici curiae* and their counsel, made any monetary contribution toward the preparation or submission of this brief. Counsel of record for all parties have consented to this filing in letters on file with the Clerk's office.

SUMMARY OF ARGUMENT

The internal consistency test reveals that Maryland applies systematically higher "county" taxes to interstate commerce than to in-state commerce.

Economic analysis of Maryland's tax regime—including its taxes on inbound, outbound, and domestic activities—confirms what the internal consistency test suggests, namely, that the Maryland "county" tax discourages interstate commerce. Specifically, the Maryland tax regime discourages Maryland residents from earning income outside of Maryland, and it simultaneously discourages nonresidents from earning income in Maryland. Maryland alone causes this distortion; the distortion does not depend on the taxes imposed by any other state.

Petitioner's argument that Maryland's outbound tax regime should be upheld because it is facially neutral when compared to Maryland's domestic tax requires the Court to ignore Maryland's inbound tax on nonresidents. Ignoring relevant parts of a state's tax regime obscures the overall effect of that regime on interstate commerce.

Although crediting other states' taxes would cure Maryland's dormant Commerce Clause violation, other practical and legitimate alternatives for curing the violation exist. Maryland, not the courts, should decide how to cure the constitutional infirmity in Maryland's tax regime.

ARGUMENT

I. Maryland's Income Tax Regime Discourages Interstate Commerce

A. The Dormant Commerce Clause Prevents States from Encouraging In-state Commerce at the Expense of Interstate Commerce

The dormant Commerce Clause of the Constitution "is the doctrine that the Commerce Clause, by its own force and without national legislation, puts it into the power of the Court to place limits on state authority." Felix Frankfurter, the Commerce Clause under Marshall, Taney & Waite, 18 (1937). Underlying the Commerce Clause is the framers' "conviction that in order to succeed the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation." *Hughes* v. *Oklahoma*, 41 U.S. 322, 325-26 (1979). Accordingly, "[o]ur [economic] system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation. . . ." *H.P. Hood & Sons, Inc. v. DuMond*, 336 U.S. 525, 539 (1949). As interpreted by this Court, the dormant Commerce Clause prohibits a state from using its tax system to "place[] burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear." *Okla. Tax Comm'n* v. *Jefferson Lines, Inc.*, 514 U.S. 175, 180 (1995).

B. Maryland's Tax Regime is Internally Inconsistent

The internal consistency test makes clear that Maryland overburdens, and hence discourages, interstate commerce as compared to purely in-state commerce. Acknowledging the importance of state tax sovereignty, this Court developed the internal consistency test as a standard for when state taxes violate the dormant Commerce Clause. Under the test,

> [i]nternal 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.

Jefferson Lines, Inc., 514 U.S. at 185.

Maryland formally divides its individual income tax into a "state" portion with a maximum rate of 4.75%, and a "county" portion with rates ranging from 1.25% to 3.2%. Md. Code Ann., Tax-General (T.G.) §§ 10-102, 10-103(a)(1). Maryland allows taxes paid to other states to fully offset the "state" portion of the tax, but it disallows any credit against the "county" tax. T.G. § 10-703(a). Since the substance of this dispute concerns only the "county"

tax, we will analyze only the "county" tax.[2] Ignoring the uncontested "state" portion of the tax, the Maryland tax regime contains the following elements:

For residents:

1. On income earned in Maryland, "county" tax of 1.25% to 3.2%, depending on the county of residence (domestic tax) T.G. § 10-103(a)(1)

2. On income earned in other states, "county" tax of 1.25% to 3.2%, depending on the county of residence, against which and there is no credit for other states' taxes (outbound tax) T.G. §§ 10-103(a)(1), 10-703

For nonresidents,

3. On income earned in Maryland, "county" tax (i.e., Special Non-Resident Tax (SNRT)) of 1.25% (inbound tax) T.G. § 10-106.1(a).[3]

2. The formal division by Maryland of its tax into "state" and "county" taxes has no effect on constitutional analysis. See, e.g., *Nippert v. City of Richmond*, 327 U.S. 416 (1946) (striking down a municipal license tax on business solicitors for violating the dormant Commerce Clause); see also *Frey v. Comptroller of Treasury*, 29 A.3d 475, 492 (Md. 2011) (concluding that Maryland's "county" income taxes were state taxes for constitutional law purposes).

3. Just as it taxes residents, Maryland subjects nonresidents with Maryland-source income to the 4.75% "state" portion of the Maryland individual income tax, but we ignore the "state" portion of the tax for purposes of this analysis. See T.G. § 10-105(d). In lieu of the SNRT, Maryland subjects nonresidents who receive compensation for employment in Maryland to the "county"

4. On income earned in other states, no tax

The Wynnes resided in Howard County, where the "county" tax rate was 3.2%, so the Wynnes paid "county" tax of 3.2% on their domestic and outbound income. *Figure 1* schematically represents the Maryland "county" tax regime for Howard county.

Figure 1. Maryland "County" Tax Regime

	Maryland Resident	Resident of Another State
Activity in Another State	*Outbound Tax* 3.2%	N/A
Activity in Maryland	*Domestic Tax* 3.2%	*Inbound Tax* 1.25%

The internal consistency test directs us to assume that every state enacts the same tax regime as Maryland, and then the test asks whether, under such hypothetical harmonization, interstate commerce suffers a greater burden than does in-state commerce. *Figure 2* shows how income would be taxed if every state (represented here by Delaware) adopted the Maryland "county" tax as employed in Howard County:

tax rates ranging from 1.25% to 3.2%. See T.G. § 10-103(a)(4). Nonresidents with Maryland income from sources other than employment pay the SNRT, which Maryland sets equal to the lowest "county" tax rate, 1.25%.

Figure 2. Maryland Tax under Internal Consistency Test

	Maryland Resident	Delaware Resident
Activity in Delaware	4.45%[4]	3.2%
Activity in Maryland	3.2%	4.45%

Figure 2 shows that the Maryland "county" tax is internally inconsistent because under hypothetical harmonization in-state income would be taxed at 3.2%, whereas interstate income would be taxed at 4.45%. The shaded quadrants in *Figure 2* represent interstate income, comprising Maryland income earned by Delaware residents and Delaware income earned by Maryland residents. In contrast, the unshaded quadrants represent in-state income, comprised of Maryland income earned by Maryland residents and Delaware income earned by Delaware residents.

4. Delaware, employing a tax regime identical to Maryland's, would impose a Special Non-Resident Tax (SNRT) of 1.25% on taxpayers, like the Wynnes, who reside in Maryland but earn income in Delaware. Maryland would not credit the Delaware SNRT against its own 3.2% residence-based "county" tax. The Delaware source-based SNRT tax (or "county tax") plus the Maryland residence-based "county" tax yields a total, source-and-residence tax rate of 4.45%.

Maryland fails the internal consistency test regardless of the county analyzed.[5] Also, Maryland fails the test regardless of whether we consider the state's tax system in its entirety—by examining both the "state" and the "county" tax together—or if we consider the "county" tax separately.[6] This is so because the Maryland "county" tax rate for interstate income is 1.25% higher than its "county" tax rate for purely in-state income.[7] Because "a law [is] discriminatory if it taxes a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State," *Fulton Corp.* v. *Faulkner*, 516 U.S. 325, 331 (1996), the Maryland Court of Appeals correctly concluded that the Maryland tax regime violates the dormant Commerce Clause. Pet. Br. App. 22.

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5. If, for example, we apply the internal consistency test to the lowest Maryland "county" tax rate of 1.25%, then in-state income is always taxed at 1.25%, whereas interstate income is always taxed at 2.5%. Maryland's "county" tax rate on cross-border income is always 1.25% higher than the "county" tax rate on domestic income.

6. Although the Maryland "state" tax passes the internal consistency test because it credits the taxes of other states, the "state" tax does not fix the internal inconsistency in the "county" tax.

7. As a theoretical matter, we could attribute this difference in tax rates to any of three features of Maryland's tax regime. We could attribute it to: (1) Maryland imposing a tax that is too low on its residents' in-state income, (2) Maryland charging a tax that is too high on residents' out-of-state income (for example, because it fails to credit other states' source taxes taxes), or (3) Maryland charging a tax that is too high on nonresidents' Maryland-source income. As we discuss later, the indeterminacy of the origin of Maryland's restraint on interstate commerce leads to multiple possible ways that Maryland could cure its constitutional violation.

The United States objects that the court below found that Maryland violated internal consistency only because the Maryland court improperly considered Maryland's 1.25% tax on nonresidents (the SNRT). U.S. Br. 24. The United States argues that "Respondents are not subject to that tax, have not challenged it, and suffer no injury from it." U.S. Br. 24. This argument misses the point that the dormant Commerce Clause protects interstate commerce, not people. Moreover, the leading treatise on state taxation explains that "the internal consistency test does not require that taxpayers demonstrate that they have actually suffered injury from the challenged tax, but only that the hypothetical application of the challenged tax by other states would subject them to a more onerous tax burden than that shouldered by taxpayers engaged in intrastate commerce." J. Hellerstein et al., *State Taxation,* ¶ 4.16[1][b] (3d ed. 2014). Finally, as shown below, the SNRT in fact harms Respondents because, in addition to discouraging nonresidents from conducting business in Maryland, the SNRT simultaneously discourages Maryland residents, including the Wynnes, from conducting business outside Maryland. *Fulton Corp.*, 516 U.S. 325 (1996) (holding that a state's intangibles tax violated the dormant Commerce Clause because it discouraged residents from investing in out-of-state companies).

C. Economic Analysis Confirms That Maryland's Tax Regime Prefers In-State To Interstate Commerce

Economic analysis shows that Maryland violates the dormant Commerce Clause because the Maryland "county" tax distorts interstate competition. Specifically, the Maryland "county" tax encourages Maryland residents to earn income in Maryland rather than in other

states, and it simultaneously also encourages nonresidents to earn income outside Maryland, rather than within Maryland. Moreover, we show that applying the internal consistency test to state taxes generates the same results as does economic analysis. Because economic analysis and the internal consistency test produce the same result, the internal consistency test is a good heuristic for evaluating whether a state's tax system violates the dormant Commerce Clause.

Whereas states apply corporate taxes using formula apportionment, states apply individual income taxes on a source and residence basis. Evaluating the impact of state individual income taxes on interstate commerce requires consideration of both source and residence taxes because states may discourage interstate commerce through their source taxes, their residence taxes, or a combination of both taxes. Thus, although Petitioner urges the Court to ignore Maryland's tax treatment of inbound commerce (Pet. Br. 34), determining whether a tax system is neutral between in-state and interstate commerce requires (as described further below) comparing how a state taxes its residents' purely in-state income with how it taxes *both outbound and inbound* economic activities.

Each state can tax three kinds of income:

(1) domestic income, which is in-state income earned by residents,

(2) outbound income, which is out-of-state income earned by residents, and

(3) inbound income, which is in-state income earned by nonresidents.

States generally lack jurisdiction under the Due Process Clause to tax the income that nonresidents earn in other states. To avoid distorting interstate competition between residents of different states, a taxing state has the freedom to set the tax rates on two of those three kinds of income, but having set the first two rates, the third rate is algebraically determined by the first two.

The economic analysis is straight-forward. The share of income that a taxpayer retains after paying tax is called a *retention rate*. *Figure 3* provides, for each kind of income taxable by Maryland, retention rates for Maryland and non-Maryland (proxied by Delaware) taxpayers after paying Maryland tax. Thus, *Figure 3* provides the *share of earnings retained after-Maryland-tax.*

Figure 3.
Retention Rates on Income Taxable by Maryland

	Maryland Resident	Delaware Resident
Activity in Delaware	*Outbound Income* $1\text{-}T_o$	1
Activity in Maryland	*Domestic Income* $1\text{-}T_d$	*Inbound Income* $1\text{-}T_i$

The retention rate for a Maryland resident on an investment in Maryland is $1\text{-}T_d$, where T_d is Maryland's tax on its residents' in-state income (i.e., Maryland's domestic tax). Likewise, the retention rate for a Maryland resident on an investment in Delaware is $1\text{-}T_o$, where T_o is Maryland's tax on residents' out-of-state income (i.e., Maryland's outbound tax).

The retention rate for a Delaware resident an investment in Maryland is 1-T_i, where T_i is Maryland's tax on nonresidents' Maryland-source income (i.e., Maryland's inbound tax). Since Maryland does not tax nonresidents' out-of-state income, a Delaware resident's after-Maryland-tax retention rate on an investment in Maryland equals 1.

Because investors allocate capital across investments in different taxing jurisdictions based upon *relative retention ratios* (i.e., comparisons of retention ratios),[8]

8. In an environment without taxes, the major result of capital asset pricing models (CAPM) is that all investors end up holding the full universe of available risky assets in the same proportion as those assets are available in the market. Investors might vary the amount of riskless debt and risky assets they hold, and of course the total amount invested in risky assets will differ depending upon the size of one's investment portfolio and attitude towards risk, but everyone will hold the same portfolio of risky assets, differing only in the size of the portfolio, but not in the relative portion of the portfolio (of risky assets) invested in each asset. The risky portfolio of assets held by each taxpayer is called the market portfolio because it is composed of a pro-rata portion of all available (risky) assets.

The after-tax capital asset pricing model (after-tax CAPM) describes how taxes affect the manner in which investors allocate their investment capital across assets in an environment with differentially taxed assets and taxpayers. The main insight from after-tax CAPM is that the intensity of an investor's demand for an asset is determined not by a simple comparison of how an investor is taxed on that asset relative to how other investors are taxed on that same asset. Instead, the intensity of an investor's demand for an asset is determined by how she is taxed on that asset relative to how she is taxed on the market portfolio as compared to how other investors are taxed on that asset relative to how they are

we need to calculate the retention ratios of Maryland and Delaware residents on investments in Maryland. A Maryland resident's *retention ratio* is the share of income remaining when she invests in Maryland relative to what remains when she invests outside Maryland (in Delaware). Thus, a Maryland resident's retention ratio on an investment in Maryland is $(1-T_d)/(1-T_o)$. In contrast, a Delaware resident's retention ratio is the share of income she retains when she invests in Maryland relative to what she retains when she invests in Delaware. Thus a Delaware resident's retention ratio on an investment in Maryland is $(1-T_i)/1$, or $1-T_i$.

taxed on the market portfolio. The central result that emerges from after-tax CAPM is that an investor will tend to invest more intensively in an asset when she is taxed lightly on an asset relative to how the same investor is taxed on the market portfolio as compared to how other investors are taxed on the asset relative to how they are taxed on the market portfolio. The converse also holds, so an investor will shy away from an asset that bears higher tax relative to the market portfolio for the investor compared to other investors' relative tax for that asset. See Michael Brennan, *Taxes, Market Valuation and Corporate Financial Policy*, 23 Nat'l Tax J. 417 (1970); Roger H. Gordon & David F. Bradford, *Taxation and the Stock Market Valuation of Capital Gains and Dividends*, 14 J. Pub. Econ. 109 (1980).

In order for taxes not to distort interstate commerce, the retention ratios across Maryland and Delaware must be the same for residents of Maryland and residents of Delaware.[9] This requirement can be written as:

$$\frac{1 - T_d}{1 - T_o} = 1 - T_i \qquad (1)$$

Equation 1 describes the condition for income taxes not to distort interstate competition in terms of *retention rates*, which are the share of pre-tax income taxpayers retain after paying Maryland tax. That presentation highlights the mechanism—individual investment choice—whereby tax affects interstate competition. It is also possible to describe the non-distortion condition in terms of *tax rates*, thereby providing states with straightforward guidelines for avoiding distorting interstate competition. After a few simple arithmetic operations, *Equation 1* can be rewritten as:

$$T_d = T_o + T_i - (T_o \times T_i). \qquad (2)$$

That is, the tax rate applied to the domestic income of residents must equal the sum of the tax rates paid by

9. How taxation affects competition between residents of different states depends upon relative retention ratios. If the parties' ratios are the same (even though their tax rates are different), then taxation will not affect where either party invests. If, however, their ratios are different, then taxation will distort competition. Ruth Mason & Michael S. Knoll, *What is Tax Discrimination?*, 121 Yale L. J. 1014, 1060-74 (2012).

residents on out-of-state income and by nonresidents on domestic income less the product of those two rates.[10] If a state's tax rates do not satisfy *Equation 2*, its tax system distorts interstate competition.[11] Notice that this equation does not specify any of the rates; rather it specifies the relationship that the rates must maintain with respect to each other. A state may set its tax rates as high or low as it wants. The dormant Commerce Clause, however, prevents a state from setting its tax on domestic income independently from its tax on interstate (inbound and outbound) income.

In addition to describing this result mathematically, in academic work *amici* describe the result more intuitively as requiring that all taxes be assessed on either a *uniform source* or a *uniform residence* basis.[12] A source tax is uniform if it applies at the same rate and on the same base[13] to both residents' and nonresidents' income from the state. A residence tax is uniform if it applies at the same rate and on the same base to residents' in-state and out-

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10. Expressed slightly differently, the tax rate Maryland applies to its residents' Maryland-source income must be the same as if Maryland first applied the rate applicable to residents' out-of-state income and then applied to the remaining income the rate applicable to nonresidents' Maryland-source income.

11. Ruth Mason & Michael S. Knoll, *Waiting for Perseus*, 67 Tax L. Rev. 375, 436-41 (2014) (providing an algebraic derivation of non-distortion conditions).

12. Mason & Knoll, *What is Tax Discrimination?*, *supra*, at 1060-74 (describing uniformity requirements for taxes not to distort competition).

13. "Tax base" refers to the rules for calculating taxable income.

of-state income. And if a state taxes on both a source and residence basis, it must apply both source and residence taxes to its residents' in-state income.

Courts interpreting the dormant Commerce Clause need not engage in the kind of economic analysis we presented here. Instead, the principle that underlies the dormant Commerce Clause—that states should not distort competition between their residents and residents of other states—generates simple rules of thumb. One rule of thumb, represented by *Equation 1*, is that a state must set tax rates so that retention ratios for residents and nonresidents are equal across jurisdictions. A second rule of thumb, represented by *Equation 2*, is that the tax rate on residents' in-state income must equal the combined tax rate on the in-state income of nonresidents and on the out-of-state income of residents.[14] A third rule of thumb is that state taxes must be uniform.

Still another rule of thumb is the Court's internal consistency test. Taxes that fail the kind of economic analysis we just conducted also will fail the internal consistency test. This equivalence arises because the hypothetical harmonization performed under the internal consistency test has the effect of applying to residents that earn out-of-state income and to nonresidents that earn in-state income both the state's treatment of nonresidents'

14. The first two rules of thumb, retention ratios and tax rates, apply when the only issue in dispute is tax rates, not tax bases. The uniformity rule and the internal consistency test apply to cases involving base or rate challenges, or both. All four rules of thumb require adjustment when the residence state provides a credit for foreign taxes. See, e.g., Mason & Knoll, *What is Tax Discrimination?*, *supra*, at 1074.

in-state income and the state's treatment of residents' out-of-state income. The internal consistency test thus calculates the combined tax rate from assessing both of those taxes and then compares the combined tax to the rate the state imposes on residents' domestic income. If the rates are the same, then there is no violation. If the rates are different, then taxes distort competition.[15] Thus, the internal consistency test asks the same question as does economics in determining whether a state's tax system distorts competition between residents of different states.

Regardless of whether we frame the inquiry for identifying tax systems that discourage interstate commerce algebraically using formulas, intuitively using uniformity rules, or schematically using the internal consistency test, the result is the same: Maryland's "county" tax discourages interstate commerce. Maryland taxes domestic income earned by Maryland residents at a lower rate (3.2%) than it taxes cross-border income

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15. Thus, not only in substance, but in form as well the internal consistency test is equivalent to the tax rate rule as described in *Equation 2*. The left side of *Equation 2*, the tax rate on domestic residents' domestic income, is the same value as in the unshaded (i.e., in-state income) quadrants of *Figure 2*. The right side of *Equation 2*, the total tax rate from applying the state's taxes on inbound and outbound commerce, is the same as the values in the shaded (i.e., interstate income) quadrants of *Figure 2*. Because the internal consistency test asks whether the tax rates in all four quadrants are equal, it is essentially asking whether *Equation 2* holds. The internal consistency test is also equivalent to the rule of thumb that retention ratios should be equal across residents of different states because that rule, which was mathematically expressed in *Equation 1*, was the source from which *Equation 2* was derived. Finally, non-uniform tax laws fail the internal consistency test because a system with non-uniform laws violates *Equation 2*.

(4.45%, comprised of the 3.2% outbound tax plus the 1.25% inbound tax).[16]

Maryland's higher taxes on interstate income than domestic income generate distortions that affect both residents and nonresidents. Specifically, Maryland discourages residents from engaging in out-of-state commerce and, at the same time, it discourages nonresidents from engaging in commerce in Maryland (including raising capital from Maryland residents). These distortions stem from Maryland alone; they will persist even if no other state imposes a tax.[17]

D. The Internal Consistency Test Is An Appropriate and Helpful Heuristic for Revealing Whether a State's Tax System Violates the Dormant Commerce Clause

Petitioner, the United States, and other *amici* argue that this Court should not apply the internal consistency test because it is clear that under the Due Process Clause Maryland has the power to tax the Wynnes' worldwide income and hence, in their view, there is no issue of fair apportionment. Pet. Br. 37, U.S. Br. 20, Multistate Tax Comm'n Br. 7. But possession by a state of jurisdiction to tax a person under the Due Process Clause does not

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16. Because Maryland does not appear to allow for the purpose of calculating "county" taxable income a deduction for taxes paid to the source state, the tax on cross-border income is 4.45%, not 4.41%.

17. For more on the two-directional distortion caused by non-uniform taxation, see Mason & Knoll, *What is Tax Discrimination?*, *supra*, at 1051-71.

immunize the state from the requirement that it exercise that jurisdiction consistently with other constitutional provisions, including the dormant Commerce Clause.

Both the fair apportionment and nondiscrimination requirements of the dormant Commerce Clause aim to ensure that a state does not discourage interstate commerce relative to in-state commerce. We take no position on whether Maryland violates the fair apportionment prong or the nondiscrimination prong of the *Complete Auto* test. *Complete Auto. Transit, Inc. v. Brady*, 430 U.S. 274 (1977).[18] Rather, we conclude that Maryland violates the dormant Commerce Clause by discouraging interstate commerce relative to in-state commerce. Because the internal consistency test provides the same result as economic analysis in evaluating whether a state tax discourages interstate commerce compared to in-state commerce (which is the central issue in dormant Commerce Clause cases), the test is useful in

18. We regard failure to apportion taxes fairly to be a subset of tax discrimination as we define it in our academic work. See Mason & Knoll, *What is Tax Discrimination?*, *supra*, at 1060-72. Cf. Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 Tax L. Rev. 131, 154 (2001) ("[a]lthough not explicitly framed as a nondiscrimination requirement, the [tax] treaty requirement of either a credit or exemption could thus be considered such a requirement"); Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 Yale L. J. 1186, 1240-1 (2006) ("the Supreme Court has invalidated state tax laws favoring in-state products, producers, and production," but that last kind of case is rare because "the U.S. states' use of formulary apportionment. . . reduces the role of residence taxation because the allocation factors generally relate to source or consumption").

both apportionment and discrimination cases. Indeed, the Court has used internal consistency to evaluate both discrimination and apportionment cases. See, *e.g.*, *Armco, Inc.* v. *Hardesty*, 467 U.S. 638 (1984) (applying internal consistency test in a discrimination case).

In arguing against applying dormant Commerce Clause analysis, including the internal consistency test, to individual income taxation of resident taxpayers, the United States notes that corporate taxes operate on "different principles" from individual income taxes. U.S. Br. 29-30. Nevertheless, the relevant question under the dormant Commerce Clause is the same as applied to individual or corporate taxes, namely, does the state discourage interstate commerce compared to in-state commerce? We see no reason why the Court should not continue to apply the logical rigor and clarity of the internal consistency test to income tax cases.

Petitioner argues that it "make[s] little sense" to apply the internal consistency test to individual income taxes. Pet. Br. 38. Accordingly, we list some of the virtues of using the internal consistency test to evaluate whether individual income taxes discourage cross-border commerce.[19]

First, the dormant Commerce Clause operates as a restraint on state taxation of individuals as well as corporations, and therefore, the same standards should

19. This analysis draws on our academic work. See Ruth Mason, *Made in America for European Tax: The Internal Consistency Test,* 49 B.C. L. Rev. 1277, 1284-1300, 1309-1319 (2008)*;* Georg Kofler & Ruth Mason, *Double Taxation: A European "Switch in Time"?,* 14 Colum. J. Eur. L. 63, 83-94 (2007).

apply to both. The failure to apply the internal consistency test (or one of the equivalent tests above) to individual taxes would create a large gap in the dormant Commerce Clause and provide states with a roadmap for restricting interstate commerce and dividing up the national market into a series of state markets. If the Court upholds Maryland's "county" tax, what would prevent Maryland from relabeling its "state" tax a "county" tax and completely eliminating credits for other states' taxes? In that case, under hypothetical harmonization, the Wynnes and their Delaware counterparts would pay tax at 7.95% on in-state income and at 15.9% on cross-border income. Such a tax would surely discourage interstate commerce in favor of in-state commerce.

Second, the internal consistency test makes it easier for courts to analyze state taxes under the dormant Commerce Clause because it allows courts to evaluate a single state's tax regime on its own terms, without the need to consider any other state's taxes. Because a court considers only one state's law under the internal consistency test, a question never arises as to *which state* generated the interstate tax disadvantage. As this Court has said, the constitutionality of one state's law should not "depend on the shifting complexities of the tax laws of 49 other States." *Armco, Inc.*, 467 U.S. 638, 644-45 (1984).

Third, the internal consistency test helps avoid judicial error. As long as they do not discriminate, states retain autonomy to set their tax rates. As a result, in the real world, adoption by other states of higher or lower tax rates than that of the challenged state may lead to false positives or false negatives, respectively, when courts attempt to discern discrimination by comparing the amount of tax

paid on interstate commerce to the amount of tax paid on purely in-state commerce. Because tax rates vary, the payment of higher, lower, or equal taxes on cross-border and in-state commerce does not dispose of the discrimination question.

Fourth, the internal consistency test helps courts distinguish tax discrimination from nondiscriminatory cases of double taxation. This Court has held that nondiscriminatory instances of double taxation, such as those arising from disparities in states' income tax bases, do not violate the dormant Commerce Clause. See, e.g., *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 279 (1978). Because the interaction of disparate, but nondiscriminatory, tax regimes may result in nondiscriminatory double or "overlapping" taxation, the absence or presence of unrelieved double taxation cannot serve as a reliable guide to whether a state's tax regime is constitutionally infirm.[20] *Moorman Mfg. Co.*, 437 U.S. at 268 (approving Iowa's single-factor apportionment formula even though

20. For example, no constitutional principle tells us who ought to be taxable on alimony, the payer or recipient. States may adopt nondiscriminatory, albeit disparate, tax policies for taxing alimony. Imagine State A taxes alimony to the recipient, and offers a deduction to the payer, while State B denies a deduction to the payer, but excludes the alimony from the income of the recipient. These regimes are different, but they both have the effect of taxing the alimony only once between the payer and the recipient, and neither discriminates. Nevertheless, a disadvantage arises when a State B resident pays alimony to a State A recipient because the A resident must include the alimony, but the B resident gets no deduction. Conversely, a double benefit would accrue to a payment from State A to State B. These advantages and disadvantages disappear under the internal consistency test's harmony assumption, which enables a court to attribute the interstate differences to disparity, not discrimination.

it could result in "some overlap" with Illinois' three-factor formula). The internal consistency test eliminates disparities in states' tax bases by hypothetically assuming that all states use the challenged state's tax rules. As a result, any double taxation that remains after application of the harmony assumption by definition cannot arise from tax base disparities, and therefore it must originate in the challenged state's tax law.

Fifth, Petitioner concedes that "[a] state tax based on residency might be subject to internal consistency analysis if the state applied the tax so that it had an impact on taxpayers who actually lived in other states." Pet. Br. 39, n.15. While Petitioner sees no such impact stemming from the challenged Maryland tax regime, the internal consistency test allows us to quickly understand the impact of a state's tax regime upon both residents and nonresidents. The two shaded regions of *Figure 2* show both the impact of the Maryland regime on Maryland residents with out-of-state income (like the Wynnes), the impact of the Maryland regime on nonresidents with Maryland income. The internal consistency test reveals what Petitioner misses: the Maryland tax regime disadvantages both outbound and inbound economic activities relative to the purely domestic activities of Maryland residents.

For these reasons, the internal consistency test represents a useful heuristic to isolate the impact of Maryland's tax law on interstate commerce.[21] That

21. See Walter Hellerstein, *Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation*, 87 Mich. L. Rev. 138, 178 (1988) (arguing

Maryland's tax regime fails the internal consistency test shows that Maryland overreaches. *Jefferson Lines*, Inc., 514 U.S. at 169 ("A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction"). Economic analysis confirms that Maryland's tax regime distorts competition between residents and nonresidents for investments within and without Maryland.

E. Tax Regimes That Discriminate Against Interstate Commerce May Contain Elements That Appear To Be Facially Neutral When Viewed In Isolation

The internal consistency test shows that whereas Maryland taxes residents' domestic income once, it taxes interstate income both coming and going. A state taxes natural persons on three kinds of income: domestic, outbound, and inbound. To get an accurate view of how a state taxes interstate commerce requires comparing how the state taxes domestic income to how it taxes both inbound and outbound income. In contrast, Petitioner's disaggregated view of the Maryland tax regime, under which courts compare a state's domestic tax to *only one of* its inbound tax or its outbound tax, allows Maryland to impede interstate commerce with impunity.

Petitioner argues that the Maryland tax does not violate the dormant Commerce Clause because it is

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that internal consistency can be seen as a "proxy for the fair apportionment criterion"). Id. at 178-88 (arguing that cases struck down for failure of internal consistence instead could have been struck down on fair apportionment grounds). Source and residence rules are the individual-income-tax analog to apportionment formulas in unitary business taxes.

facially neutral; Maryland taxes residents' in-state and out-of-state income at the same "county" rate, namely 3.2%. Pet. Br. 35-36. But that neutrality holds only when we isolate Maryland's tax on outbound transactions and compare it to Maryland's tax on domestic transactions. As the internal consistency test vividly demonstrates, this so-called neutrality depends on ignoring Maryland's tax on inbound transactions.

Examining state taxes on just two out of the three kinds of income produces misleading results. For example, in a recent case, *Comptroller* v. *Frey*, 29 A.3d. 475 (Md. 2011), *cert. denied* 132 S.Ct. 1796 (2012), the Maryland Court of Appeals considered whether Maryland's inbound tax (the SNRT) discriminated against interstate commerce. Although the Maryland Court of Appeals concluded that the inbound tax was facially discriminatory because it applied only to nonresidents, the Maryland court nevertheless held that the inbound tax did not violate the dormant Commerce Clause because it was no higher than Maryland's domestic tax.[22]

Thus, in *Frey,* at the urging of the Maryland Comptroller, the Maryland Court of Appeals considered whether Maryland discriminated against *only inbound* commerce. Now, just five years later in *Wynne*, Petitioner asks the Supreme Court to evaluate the question of

22. *Frey* involved a Delaware resident who was a partner in a limited liability partnership that earned some of its income in Maryland. The Maryland-source income was subject to both the "state" and "county" portions of Maryland's income tax on nonresidents. The Court of Appeals concluded that the "county" tax on nonresidents, the SNRT, "is a facially discriminatory tax." *Frey*, 29 A.3d. at 497.

whether Maryland discriminates against *only outbound* commerce.

Combining *Frey* with *Wynne* shows the problem. In *Frey*, Petitioner succeeded in urging the Maryland Court of Appeals to compare Maryland's 1.25% tax on inbound income with its 3.2% tax on domestic income. *Frey*, 29 A.3d at 496, 505. And now, in *Wynne*, Petitioner asks the Supreme Court to compare Maryland's 3.2% tax on outbound income with the *same* 3.2% tax on domestic income. By double-counting the domestic tax, Petitioner was able to construct: (1) in *Frey* a facially preferential-to-outsiders comparison of domestic and inbound taxes (3.2% versus 1.25%) and (2) in *Wynne* a facially neutral comparison of domestic and outbound taxes (3.2% versus 3.2%).[23]

Double-counting the domestic tax obscures that whereas Maryland taxes residents' domestic income once, it taxes interstate commerce coming and going.[24] The combined Maryland taxes on interstate commerce (i.e., the inbound tax plus the outbound tax) sum to 4.45%,

23. Our analysis uses the highest "county" tax rate of 3.2%, but the actual "county" rate depends on the taxpayer's county of residence and ranges from 1.25% to 3.2%. The "county" tax rate on nonresidents (SNRT) is set equal to the lowest "county" rate, which is 1.25%. The analysis here holds, no matter which "county" rate we consider.

24. To avoid discouraging interstate commerce, Maryland could, for example, impose *both* taxes—the residence tax *and* the source tax—on residents' Maryland income. In that case, Maryland would have uniform taxes—a uniform source tax of 1.25% and a uniform residence tax of 3.2%. But there are other alternatives for Maryland to cure its violation, as we discuss below.

thus exceeding the Maryland tax on residents' domestic income of 3.2%. If all states adopted similar regimes, interstate commerce would always face more tax than domestic commerce.

Understanding the economic impact of a state's tax on interstate commerce requires analysis of how the state taxes *both inbound and outbound* commerce. Courts must compare a state's treatment of inbound and outbound commerce to the state's treatment of purely domestic commerce. Isolating and comparing the tax on only two out of three types of income provides a partial analysis that may obscure discrimination, whereas analyzing all relevant parts of a state's tax regime comports with the underlying economics as well as the Court's dormant Commerce Clause precedent. The Court regularly looks to disparate parts of a state's tax code to evaluate so-called compensatory tax schemes, under which a "facially discriminatory tax survives strict scrutiny if it is the 'rough equivalent of an identifiable and 'substantially similar' tax on intrastate commerce.'" *Frey,* 29 A.3d at 494 (quoting *Or. Waste Sys.* v. *Dep't of Env't Quality*, 511 U.S. 93, 103 (1994)). This case involves a facially neutral tax that has a discriminatory impact when seen in light of a substantially similar tax on inbound commerce.

Failure to adopt a comprehensive view of a state's tax regime—by considering how the state taxes all of domestic, inbound, and outbound commerce—raises the risk that states will eviscerate the protection that the dormant Commerce Clause provides for interstate commerce by embedding discriminatory tax provisions in disparate parts of their tax regimes. Whether used as heuristics antecedent to economic analysis or as standards

in and of themselves, the rules of thumb described above, including the internal consistency test, prevent disaggregation of the state tax regime into inbound-only and outbound-only elements. As a result, they prevent the kind of incomplete analysis urged by Petitioner both in the instant case and in *Frey*.

II. Maryland Can Cure Its Commerce Clause Violation In Several Ways, None Of Which Depends On The Taxes Collected By Any Other State

The economic analysis above leads to the conclusion that the Maryland tax regime violates the dormant Commerce Clause because it discourages interstate commerce compared to in-state commerce. Although the Supreme Court should find the Maryland "county" tax unconstitutional, there are several ways for Maryland to cure the infirmity, and Maryland, not the courts, should choose the cure.

Although economic analysis shows that Maryland's tax regime discourages Maryland residents from engaging in commerce outside Maryland while simultaneously discouraging nonresidents from engaging in commerce inside Maryland, economic analysis does not and cannot tell us whether Maryland discriminates on either an outbound basis or an inbound basis. Economic analysis (and the internal consistency test) tell us that a state tax regime that does not meet the equivalence in *Equation 2* distorts competition between residents and nonresidents. However, economic analysis does not specify which term in that equation, that is, which tax rate, should change to make the two sides of the equation balance. For example, we cannot conclusively attribute the distortion caused by

Maryland's tax regime exclusively to its outbound taxation in the form of its failure to credit other states' taxes; nor can we conclusively trace the distortion exclusively to Maryland's inbound taxation in the form of the SNRT.

If the Supreme Court affirms the decision of the Maryland Court of Appeals, then Maryland has several options. It can:

(1) raise its domestic tax, T_d,

(2) lower its outbound tax, T_o, including by crediting other states' taxes against its "county" tax or by exempting residents' income earned in other states,

(3) lower its tax on inbound activities, T_i, or

(4) any combination of (1) through (3) that satisfies the tax rate rule given in *Equation 2* or equivalently is internally consistent.

Although crediting other states' taxes generally will cure a state's internal inconsistence,[25] because Maryland

25. J. Hellerstein et al., *State Taxation*, *supra*, ¶ 4.16[1][b] (approving the lower court's decision in *Wynne*). A common approach would be for Maryland to credit other states' taxes up to the amount of its own tax on outbound investments. Cf. Warren, *supra*, at 153 (describing the commitment in tax treaties to either a foreign tax credit or exemption as aiming to "reduce impediments to international commerce"). However, Maryland could provide a smaller credit and still satisfy internal consistency. For example, Maryland could increase its foreign tax credit by the amount of the SNRT of 1.25%. By increasing the tax credit from 4.75% to 6%, Maryland effectively makes the creditable portion of its tax

can cure its Commerce Clause violation in a number of ways, and the Constitution provides no guidance for which way is best, discretion lies with Maryland.[26] The Supreme Court need not, and should not, choose a particular option for Maryland. Rather, it is up to Maryland to decide how to cure its violation.

Indeed, upon a motion for reconsideration, the Maryland Court of Appeals clarified that,

> A state may avoid discrimination against interstate commerce by providing a tax credit, or some other method of apportionment, to avoid discriminating against interstate commerce in violation of the dormant Commerce Clause. The Comptroller interprets a footnote in our earlier opinion to hold that a state must provide

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system a 6% worldwide tax with a full credit coupled with a 6% tax on Maryland-source income of nonresidents. That leaves the rest of the Maryland tax as a uniform, 1.95% residence tax without a credit on Maryland residents' domestic and out-of-state income. For a discussion of the requirements for state taxes not to distort interstate commerce when the taxing state is offering a credit for taxes paid to other states (which differ from those when the state is not offering a credit), see Mason & Knoll, *What is Tax Discrimination?*, *supra*, at 1063-64, 1072-74.

26. That is, the Constitution gives no answer to the question whether (for Howard County's 3.2% tax rate) Maryland should, for example: (1) increase *Domestic Quadrant* tax to 3.2 + 1.25 – (3.2% x 1.25%) = 4.41%, (2) reduce the *Outbound Quadrant* tax either by eliminating that tax or by allowing a full credit against other states' taxes to reduce Maryland's 3.2% tax on outbound activities, or (3) eliminate the 1.25% *Inbound Quadrant* tax. The choice of how to equalize *Equation 2* remains the sovereign choice of Maryland.

> a tax credit. Slip Op. at pp. 28-29 n.26. While the footnote might have been worded more elegantly, it referred primarily to the method used by the Legislature in the Maryland income tax; we did not mean to preclude other methods that might be utilized in other contexts.

Pet. Br. App. 51-52.

Moreover, affirming the lower court's decision does not spontaneously generate a need to resolve which state—Maryland or the state where the Wynnes earned their income—has priority to tax that income. Affirmation that Maryland's individual income tax regime violates the dormant Commerce Clause does not compel full creditability as the sole remedy, and therefore, contrary to Petitioner's suggestion, it does not amount to a requirement that "the Maryland tax must give way in favor of taxes paid to other states." Pet. Br. 31.

Nor would affirming the lower court bar Maryland from taxing its own residents' out-of-state income. Petitioner argues that a requirement for Maryland to credit other state's taxes would mean that Maryland "is effectively barred from taxing its residents' out-of-state income to the extent that another state has already taxed that income." Pet. Br. 13. This would, in Petitioner's terms, create an "all-take-and no-give arrangement" between Maryland and its residents with out-of-state income because those residents would receive government services from Maryland without having to pay tax. Pet. Br. 24. But, consistently with the dormant Commerce Clause, Maryland can tax nonresidents' out-of-state income at whatever rate it chooses. What Maryland cannot do, however, is set that rate independently of its

rates on domestic and inbound commerce. Maryland's tax on interstate commerce can be no higher than its tax on domestic commerce. As a result, raising its tax on outbound commerce may, under certain circumstances, necessitate raising its tax rate on domestic commerce. That may be politically painful, but the alternative currently in force in Maryland is unconstitutional.

As our analysis makes clear, and contrary to Petitioner's suggestions, none of the options available to Maryland to cure its dormant Commerce Clause violation depends in any way on the actions taken by any other state. Pet. Br. 34, 41.

III. Conclusion

The crucial question under the dormant Commerce Clause is whether a state tax policy "establishes an economic barrier against competition" or an "unreasonable clog upon the mobility of commerce." *Moorman Mfg. Co.*, 437 U.S. at 287-88 (Powell, J., dissenting). As the discussion above makes clear:

The Maryland "county" tax discourages interstate commerce in favor of in-state commerce. The tax regime adversely affects both residents with out-of-state income and nonresidents with in-state income. Thus, the Maryland "county" tax violates the dormant Commerce Clause and so the Court should hold.

Economic analysis and the internal consistency test yield the same results for whether a state tax distorts commerce because both methods test for the same rate equivalence. The internal consistency test therefore represents a simple way for the Court to determine

whether or not a state's tax favors in-state commerce over interstate commerce. The test also reduces the risk that parts of a state tax regime, considered in isolation, will appear to pass constitutional muster even though combining the challenged rule with other parts of the state's tax regime reveals systematic discouragement of interstate commerce.

Maryland can cure the constitutional infirmity in its "county" tax in multiple ways. Accordingly, the Court should affirm the decision below and send the case back to Maryland so that the Maryland legislature can decide how to render the tax consistent with the Commerce Clause. The Court need not, and should not, require Maryland to provide a tax credit for taxes paid to other jurisdictions up to the amount of the "county" tax.

Respectfully submitted,

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