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No. 13-485

IN THE

# Supreme Court of the United States

COMPTROLLER OF THE TREASURY OF MARYLAND,
*Petitioner,*

v.

BRIAN WYNNE, ET UX,
*Respondents.*

**On Writ of Certiorari to the Court of Appeals of Maryland**

# BRIEF FOR TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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## STATEMENT OF INTEREST[1]

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. submits this brief as *amicus curiae*. Tax Executives Institute ("TEI" or "the Institute") is a voluntary, nonprofit association of

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[1] No party or counsel for a party wrote this brief in whole or in part. No party, counsel for a party, or person other than Tax Executives Institute, its members, or its counsel made a monetary contribution intended to fund the preparation or submission of this brief.

corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. TEI was organized in 1944 under the laws of the State of New York and is exempt from taxation under section 501(c)(6) of the Internal Revenue Code (26 U.S.C.). The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws, reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and defending Commerce Clause protections and the constitutional rights of business taxpayers.

The members of the Institute represent a cross section of the business community. The multi-jurisdictional companies represented by the Institute's membership are significantly affected by the rules governing state taxes generally, and especially those governing the allocation and apportionment of income among the various States. As a result, nearly all Institute members will be affected by the resolution of this case, which addresses the treatment of income earned from commercial activities conducted in an active business operating in interstate commerce. Unless the decision of the Court of Appeals of Maryland is affirmed, business taxpayers throughout the Nation will face substantial uncertainty, suffer heightened costs and burdens of compliance, and be at risk of duplicative taxation. As individuals who must contend daily with the interpretation and administration of the Nation's tax laws, the Institute's members have a vital interest in the proper disposition of this case.

## SUMMARY OF ARGUMENT

The question presented in this case is whether the State of Maryland's failure to provide an effective

mechanism in its individual income tax to mitigate the risk of double taxation on income earned from commercial activities conducted outside the State violates the Commerce Clause of the United States Constitution. It does.

Under this Court's jurisprudence, a state tax violates the Commerce Clause if it discriminates against interstate commerce or subjects interstate commerce to the risk of cumulative taxes of several States. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938). Such taxation is proscribed because the "fundamental purpose of the [Commerce] Clause is to assure that there be free trade among the several States," *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 335 (1977), and because extraterritorial taxation constitutes an "unreasonable clog on the mobility of commerce." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935).

Like most States, Maryland imposes an income tax on individuals. The tax has three parts: (1) a state income tax; (2) a county income tax; and (3) a tax on those subject to the state income tax but not the county tax (*i.e.*, non-residents of Maryland). Md. Code Ann., Tax-Gen. §§ 10-102, 10-103, 10-105(a), 10-106, 10-106.1.[2] Individual residents of Maryland are taxable on all income regardless of its source, while non-residents are taxable only on their income derived from Maryland sources. To mitigate double taxation

[2] All parts of the Maryland individual income tax scheme are treated as state taxes. *Frey* v. *Comptroller of Treasury*, 29 A.3d 475, 492 (Md. 2011) ("[T]he county tax levied under [Md. Code Ann., Tax-Gen.] § 10-103 and § 10-106 is a State tax.").

for Maryland residents, Maryland provides a credit against the state portion of its individual income tax for income taxes paid to other states. Md. Code Ann., Tax-Gen. § 10-703(a). A similar credit was provided for the county portion of the tax until 1975 when the General Assembly of Maryland repealed it. Chapter 3, Laws of Maryland 1975. The General Assembly has neither replaced that credit nor enacted another mechanism to mitigate the risk of multiple taxation on interstate business income subject to the county portion of the Maryland individual income tax.

The calculation of the Maryland individual income tax base largely follows that of the Internal Revenue Code. Under Subchapter S of the Internal Revenue Code, certain corporations can elect to be treated as "pass-through" entities whose income is not taxed at the corporate level, but rather is reported and taxed on a pro rata basis by the shareholders of the corporation. 26 U.S.C. §§ 1362(a), 1363, 1366 (such electing corporations are commonly referred to as "S corporations"). The items of income, loss, deduction, and credit generated by an S corporation retain their character and flow directly to the shareholders who are subject to tax at the shareholder level——as if the shareholders were directly operating the business of the S corporation. 26 U.S.C. § 1366(b). Maryland has adopted these federal provisions, and the items of income, loss, deduction, and credit of an S corporation, as well as the character of such items, become part of the shareholders' Maryland individual income tax computations. Md. Code Ann., Tax-Gen. § 10-107.

The income at issue in this case arose from the active conduct of an S corporation's multistate business. Maxim Healthcare Services, Inc. ("Maxim") provides home health, medical staffing, and wellness

services throughout the United States. The taxpayers, Brian and Karen Wynne, are Maryland residents who owned 2.4% of Maxim's stock in 2006, the taxable year at issue. Pursuant to Maxim's S corporation status, the Wynnes reported their pro rata share of the items of income, loss, deduction, and credit from Maxim's business on returns filed in 39 States, including Maryland. Maxim or its shareholders (or both) paid income tax in those 39 states.[3] The Wynnes claimed a credit on their Maryland income tax return for taxes paid to other States under Md. Code Ann., Tax-Gen. § 10-703(a). No such credit, however, was available to offset the county portion of the Maryland individual income tax.

States may tax interstate commerce without violating the Commerce Clause. *See Western Live Stock*, 303 U.S. at 254 ("It was not the purpose of the Commerce Clause to relieve those engaged in interstate commerce from their just share of state tax burden."). The Commerce Clause prohibits, however, state taxes and duties that hinder and suppress interstate trade by discriminating against or unduly burdening interstate commerce. *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 (1992). In *Complete Auto*, this Court set forth a four-prong test for determining whether a State tax violates the limits imposed by the Commerce Clause. Under that test, a tax will be sustained only if (1) it is applied to an activity with a substantial nexus with the taxing State, (2) it is fairly apportioned, (3) it does not discriminate against interstate commerce, and (4) it is

[3] Unlike Maryland, some States do not follow the federal income tax treatment of S corporations and tax such entities at the corporate level.

fairly related to the services provided by the State. 430 U.S. at 279.

The Commerce Clause applies to all state taxes that affect interstate commerce, regardless of their labels or on whom they are imposed. *See Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 574-75 (1997). Petitioner argues that merely labeling a state tax as a personal income tax on state residents eviscerates the Commerce Clause protections afforded interstate commerce. *See* Comptroller Br. 26-27. This is simply wrong and ignores the uniform application of the Commerce Clause to state taxes affecting interstate commerce established by this Court in *Complete Auto* and its progeny. This Court has applied the *Complete Auto* test to evaluate the constitutionality of a wide variety of state taxes, including taxes imposed against individual residents of a State. *See, e.g.*, *Goldberg v. Sweet*, 488 U.S. 252 (1989).

Maryland's efforts to exclude a subset of interstate commerce—that earned by a pass-through entity—from the protections afforded by the Commerce Clause run counter to the Court's jurisprudence by exalting statutory form over substance. If the lower court's decision is reversed, business taxpayers would face the potential for future exceptions to the protections from overly burdensome taxation provided by the Commerce Clause. For example, a State might claim the Commerce Clause has no application to the taxation of business entities in the State of their commercial domicile thereby creating significant risk of multiple taxation. *See* U.S. Brief at 31 ("It is an open question whether States are constitutionally *required* to apportion the income of a domestic corporation."). (Emphasis in original.)

The county portion of Maryland's individual income tax fails to withstand Commerce Clause scrutiny required under *Complete Auto*. The second prong of that test requires a state tax to be fairly apportioned. *Complete Auto*, 430 U.S. at 279. This prong ensures "there is no danger of interstate commerce being smothered by cumulative taxes of several states." *Complete Auto Transit Inc. v. Brady*, 330 S.2d 268, 272 (1976). Under Maryland's scheme, the county portion of the tax fails the test because it does not provide a mechanism to mitigate the risk of duplicative taxation on income earned from interstate commerce. Such a risk, by itself, contravenes this constitutional restriction on States' taxing powers. *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434, 439 (1939). The risk of double taxation alone violates the Commerce Clause; no actual double taxation need exist. "[T]he con-stitutionality of [one State's] tax should not depend on the vagaries of [another State's] tax policy." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 444 (1980). The Maryland taxing scheme in issue provides no relief from multiple taxation for income earned from the operation of a business operating in interstate commerce. The absence of such relief creates an unconstitutional risk that interstate commerce conducted by residents of Maryland will be unduly burdened. Accordingly, the decision below should be affirmed.

Petitioner argues that affirming the court below would infringe on Maryland's sovereign power to tax the entire income of it residents, "including income earned outside [its] borders." Comptroller Br. 17 (citing *Okla. Tax Comm'n v. Chickasaw Nation*, 515 U.S. 450, 463 (1995)). That position, however, ignores the restrictions imposed by the Commerce Clause on state taxes involving commerce conducted across state

lines. Indeed, the only income at issue in this case is commercial income earned by Maxim's business from activities conducted in the 39 States where it filed tax returns. No other income is at issue here.

None of the cases cited by Petitioner in support of its assertion that States are constitutionally free to tax any and all income of their residents address the Commerce Clause restrictions on a State's right to tax. *See, e.g.*, *Chickasaw Nation*, 515 U.S. 450 (treaty did not prohibit State from taxing income of tribal members living off reservation); *New York v. Graves*, 300 U.S. 308 (1937) (Due Process Clause did not bar New York from imposing income tax on rental and interest income of resident earned from real property located in New Jersey); *Lawrence v. State Tax Comm'n*, 245 U.S. 37 (1932) (neither the Due Process Clause nor the Privileges and Immunities Clause prohibited Mississippi from imposing its income tax on income earned by an individual from the construction of public highways in Tennessee). None of the foregoing cases address the application of the Commerce Clause limitations to a State's right to tax. The United State's argument that a State's relationship with its individual residents differs from its relationship with its domiciliary corporations is similarly misguided. This Court has applied Commerce Clause protections to individuals in the same manner as it has to corporations. *See, e.g.*, *Goldberg*, 488 U.S. 252.

In certain cases, the Commerce Clause's prohibition against overly burdensome multiple taxation of interstate businesses requires allocation of income in full to a single State. Thus, for a corporation, the domiciliary State may tax in full income derived from an unrelated business activity constituting a "discrete business

enterprise." *Exxon Corp. v. Dep't of Revenue of Wis.*, 447 U.S. 207, 224 (1980) (quoting *Mobil Oil,* 445 U.S. 425, 442, 439). A common example of fully allocable income is gain from the sale of a subsidiary or division that was unrelated to the operation of the corporation's main business. *See, e.g.*, *MeadWestvaco Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16 (2008) (applying the "unitary business" doctrine to the sale of a division of a corporation). Requiring allocation of such income in full to a single State vindicates the Commerce Clause restrictions on States' taxing authority because it eliminates the risk of double taxation by constraining the ability of any State except the State of the corporation's commercial domicile to tax it. The income at issue in this case, however, is not fully allocable income.

*Amicus* the Multistate Tax Commission posits that the income generated by Maxim in the active conduct of its business is transformed into investment income when it passes through to its S corporation shareholders. Br. 4, 10, 11. The only income at issue for the Wynnes is business income from the operation of Maxim's multistate business. By virtue of Maryland law and its adoption of the federal treatment of S corporations, the character of Maxim's income did not change as it passed through to the Wynnes. It remains income from the active conduct of a multistate business and must be treated accordingly for purposes of analyzing the Commerce Clause limitations on Maryland's power to tax. The court below correctly applied the Commerce Clause limitations articulated by the *Complete Auto* test to Maryland's tax on that income and properly concluded that the absence of a mechanism in the county portion of the Maryland individual income tax to mitigate the risk of multiple taxation is unconstitutional.

## ARGUMENT

### I. THE COMMERCE CLAUSE REQUIRES STATES TO MITIGATE THE RISK OF MULTIPLE TAXATION OF BUSINESS INCOME EARNED IN INTERSTATE COMMERCE.

#### A. The Commerce Clause Applies to All State Taxes Affecting Interstate Commerce.

By allocating the Wynne's pro rata share of income derived from Maxim's commercial activities conducted in 39 States fully to the State of Maryland and subjecting it to the county portion of the state income tax without providing any mitigation against the risk of multiple taxation, Maryland violated the limits imposed by the Commerce Clause on States' ability to tax multistate businesses. U.S. Const. art. I, § 8, cl. 3.

Within our federal system of government, States retain broad authority to legislate and govern within their borders. Those powers, however, are not absolute. *See Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 449 (1827) ("[T]he taxing power of the states must have some limits."); *McCulloch v. Maryland*, 17 U.S. 316, 427 (1819) ("[T]he sovereignty of the state, in the article of taxation itself, is subordinate to, and may be controlled by the Constitution of the United States."). The Commerce Clause limits state power by acting as a brake against overly burdensome state regulation that would constitute an "unreasonable clog upon the mobility of commerce." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935).

Under the Commerce Clause, state taxes may not discriminate against, nor unduly burden, interstate commerce. *Quill Corp. v. North Dakota*, 504 U.S. 298,

312 (1992) (citing *Philadelphia v. New Jersey*, 437 U.S. 617 (1978) and *Kassel v. Consolidated Freightways Corp. of Del.*, 450 U.S. 662 (1981)). The Constitution proscribes such taxation because the "fundamental purpose of the [Commerce] Clause is to assure that there be free trade among the several states." *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 335 (1977). Given the purpose and intent of the Commerce Clause, "[s]tate taxation falling on interstate commerce . . . can only be justified as designed to make such commerce bear a fair share of the cost of the local government whose protection it enjoys." *Freeman v. Hewitt*, 329 U.S. 249, 253 (1946). *See also Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938). Hence, a balance must be struck between a State's need for revenue to fund services provided to taxpayers and taxpayers' right to protection from overreaching tax authorities. This Court has long made "the delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual States in exercising their taxing powers." *Boston Stock Exchange*, 429 U.S. at 329.

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), the Court encapsulated its earlier holdings and articulated a four-prong test for determining whether a state tax statute violates the Commerce Clause. In doing so, the Court overruled a line of earlier cases holding "that a tax on the 'privilege' of engaging in an activity in the State may not be applied to an activity that is part of interstate commerce." *Id.* at 278. "[A]ny consideration of the practical effect of the tax" was irrelevant to the application of that rule. *Id*. This rigid approach was referred to as the *Spector* rule, named for a case that applied the construct to a Connecticut corporate franchise tax on foreign

corporations. *See Spector Motor Service v. O'Connor*, 340 U.S. 602 (1951).

Two cases following closely on the heels of *Spector* highlighted the untenable formalism of the rule and its disregard for the actual effects of a state tax on interstate commerce. In *Railway Express Agency v. Virginia*, 347 U.S. 359 (1954), the *Spector* rule was applied to an annual license tax imposed by Virginia on "gross receipts for 'the privilege of doing business in this State,'" which was measured by "'all receipts earned in this State on business passing through, into, or out of this State.'" *Id.* at 362, 367. Applying the *Spector* rule, the Court held that the tax unconstitutionally burdened interstate commerce because the tax was imposed on the privilege of doing business in the State and was measured by gross receipts generated in interstate commerce. *Id.* at 369. In response to this result, the Virginia legislature amended its law to impose a franchise tax measured by gross receipts from operations in Virginia. *Railway Express Agency v. Virginia*, 358 U.S. 434 (1959). The Court held that the revised statute did not violate the *Spector* rule despite the lack of any "real economic difference between" the two statutes. *Complete Auto*, 480 U.S. at 284.

"The *Spector* rule had come to operate only as a rule of draftsmanship, and served only to distract the courts and parties from their inquiry into whether the challenged tax produced results forbidden by the Commerce Clause." *Id*. at 285. Declaring that "the *Spector* rule does not address the problems with which the Commerce Clause is concerned," *id*. at 288, the Court overruled *Spector* and adopted a four-prong test designed to consider "not the formal language of the tax statute, but rather its practical effect." *Id.* at 280.

Petitioner's argument attempts to resurrect the formalism of *Spector* in the case of state individual income taxes, focusing on the labeling of the tax rather than its effects on interstate commerce. The position ignores the teaching of *Complete Auto* and seeks to reshape the long-recognized protections the Commerce Clause affords interstate businesses.

Specifically, the Court in *Complete Auto* held that a state tax will survive Commerce Clause scrutiny only if it (1) is applied to an activity with a substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the State. *Id.* at 279. *Complete Auto* thus provides a framework for balancing competing interests among various States in which a taxpayer conducts business to determine whether a particular State's tax unduly infringes on interstate commerce.

The *Complete Auto* test has been applied to evaluate the constitutionality of a wide variety of state taxes. *See, e.g.*, *Quill Corp.,* 504 U.S. 298 (use tax); *Trinova Corp. v. Dep't of Treasury*, 498 U.S. 358 (1991) (state value-added tax); *Goldberg v. Sweet*, 488 U.S. 252 (1989) (telecommunications excise tax) (citing *D.H. Holmes Co. v. McNamara*, 486 U.S. 24 (1988) (use tax)); *Wardair Canada Inc. v. Florida Dep't of Revenue*, 477 U.S. 1 (1986) (sales tax on fuel used in international commerce); *Commonwealth Edison Co. v. Montana*, 453 U.S. 609 (1981) (severance tax); *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) (corporate income tax); *Washington Dep't of Revenue v. Association of Washington Stevedoring Cos.*, 435 U.S. 734 (1978) (business and occupation tax). The *Complete Auto* test focuses on the substance of the taxes in issue, not their form, and

applies to taxes assessed against resident individuals in the same manner as it applies to corporate entities. *See, e.g.*, *Goldberg,* 488 U.S. 252 (applying *Complete Auto* to an Illinois telephone excise tax imposed on a resident individual). *See also Camps Newfound/ Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997) (local property tax exemption for resident non-profit organizations found to violate Commerce Clause). Regardless of their labels, all of these state taxes implicated interstate commerce, making them subject to the limitations imposed by the Commerce Clause.

Petitioner argues that merely labeling a state tax as a personal income tax on state residents eviscerates Commerce Clause protections afforded interstate commerce. *See* Pet. App. 26-27. This is wrong because it fails to reflect the uniform application of the Commerce Clause to state taxes affecting interstate commerce as established by this Court in *Complete Auto* and its progeny. Interstate commerce is no less interstate commerce when accomplished by a corporation than when performed by a sole proprietor, partnership, or other business entity. Taxation of that commerce has been, and should continue to be, measured using the same constitutional yardstick—*i.e.*, *Complete Auto*'s four-prong test.

Carving out a subset of interstate commerce from the protections afforded by the Commerce Clause based on the individual or entity earning it is illogical and runs counter to the analysis and holding in *Complete Auto*. *See also Camps Newfound*, 520 U.S. at 584 ("We see no reason why the nonprofit character of an enterprise should exclude it from the coverage of either the affirmative or the negative aspect of the Commerce Clause."). If this theory were adopted, it

would "distract the courts and parties from their inquiry into whether the challenged tax produced results forbidden by the Commerce Clause," *Complete Auto*, 430 U.S. at 285, thereby inviting future exceptions to the protections from overly burdensome taxation provided by the Commerce Clause. For example, a State might claim the Commerce Clause has no application to the taxation of business entities in the State of their commercial domicile thereby creating a significant risk of multiple taxation. *See*, *e.g.*, U.S. Br. 31 ("It is an open question whether States are constitutionally *required* to apportion the income of a domestic corporation in that fashion."). (Emphasis in original.) The resulting uncertainty would raise the cost to business taxpayers of complying with their tax obligations, increasing the costs of administration for all stakeholders.

### B. The Absence of a Mechanism to Mitigate Multiple Taxation of Income Earned in Interstate Commerce Violates the Commerce Clause.

Applying the *Complete Auto* test to the county portion of Maryland's individual income tax demonstrates that it cannot withstand Commerce Clause scrutiny. The taxpayer does not argue that there is a lack of substantial nexus or that the Maryland tax does not fairly relate to the services provided by the State. Rather, the taxpayer is concerned about the second and third prongs of the *Complete Auto* test.[4]

"The second and third parts of that [*i.e.*, the *Complete Auto*] analysis, which require fair appor-

[4] Our analysis addresses only the fair apportionment prong of the *Complete Auto* test. Respondent and other *amici* adequately cover the discrimination prong of the test in their briefs.

tionment and nondiscrimination, prohibit taxes that pass an unfair share of the tax burden onto interstate commerce." *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 (1992). The Commerce Clause does not prohibit States from taxing income earned in interstate commerce, but ensures that the burden imposed by the tax does not strangle business conducted across state lines. The Mississippi Supreme Court summarized the rule and its intent well in its opinion in *Complete Auto*, which was ultimately upheld by this Court:

> It will be noted that Taxpayer has a large operation in this State. It is dependent upon the State for police protection and other State services the same as other citizens. *It should pay its fair share of taxes so long, but only so long, as the tax does not discriminate against interstate commerce, and there is no danger of interstate commerce being smothered by cumulative taxes of several states*.

*Complete Auto Transit Inc. v. Brady*, 330 So.2d 268, 272 (1976). (Emphasis added.)

A state tax violates the Commerce Clause under the fair apportionment prong unless it provides a mechanism to mitigate the risk of duplicative taxation on income earned from interstate commerce. *Complete Auto*, 430 U.S. at 279. Such a risk, by itself, contravenes the constitutional restriction on States' taxing powers. *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434, 439 (1939). *See also Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 444 ("[T]he constitutionality of [one State's] tax should not depend on the vagaries of [another State's] tax policy.").

Despite the high regard afforded apportionment as a method for avoiding unconstitutional multiple taxation on multistate business income, the Commerce Clause does not require States to use a single mechanism to address the risk of multiple taxation of business income. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978). In *Goldberg v. Sweet*, the Court analyzed the constitutionality of a telephone excise tax imposed on an individual by the individual's State of residence, *i.e.*, Illinois, and found no violation of the Commerce Clause in part because Illinois provided a tax credit for taxes paid to other States. 488 U.S. 252, 264 (1989) ("To the extent that other States' telecommunications taxes pose a risk of multiple taxation, the credit provision contained in the Tax Act operated to avoid actual multiple taxation.") (Citations omitted.) The Maryland General Assembly eliminated any mechanism for mitigating double taxation for the county portion of the State's individual income tax system when it repealed its credit for taxes paid to other States in 1975, leaving in place an unconstitutional levy affording no relief against burdensome multiple taxation. Chapter 3, Laws of Maryland 1975.

Maryland provides neither apportionment relief for the county portion of its individual income tax nor a credit mechanism to afford relief from multiple taxation of multistate business income. The absence of any relief from multiple taxation creates an unconstitutional risk that interstate commerce conducted by residents of Maryland, including through a pass-through entity such as an S corporation, will be unduly burdened. The court below correctly held that the amendment to the county portion of the state income tax in 1975 eliminating the

credit for taxes paid to other States violated the Commerce Clause, and its holding should be affirmed.

### C. The Cases Cited by Petitioner Do Not Address the Commerce Clause Limits Placed on State Taxing Powers.

Petitioner and its *amici* cite examples of taxpayers who challenged multiple taxation of income earned by the State of an individual's residence under the Due Process Clause of the Fourteenth Amendment, the Privileges and Immunities Clause, and the Equal Protection Clause among other constitutional provisions. *See* Pet. Brief at 18; U.S. Brief 12. None of those cases, however, involves the application of the Commerce Clause to a State's taxation of income generated in interstate commerce. *See*, *e.g., Okla. Tax Comm'n v. Chickasaw Nation*, 515 U.S. 450 (1995) (treaty did not prohibit State from taxing income of tribal members living off reservation); *New York v. Graves*, 300 U.S. 308 (1937) (Due Process Clause does not bar New York from imposing income tax on rental and interest income of resident earned from real property located in New Jersey); *Lawrence v. State Tax Comm'n*, 245 U.S. 37 (1932) (neither the Due Process Clause nor the Privileges and Immunities Clause prohibits Mississippi from imposing its income tax on income earned by an individual from the construction of public highways in Tennessee).

Acting within the limits of one part of the Constitution, however, does not give States a free pass to ignore other constitutional requirements. As this Court has observed "[a] tax may be consistent with due process and yet unduly burden interstate commerce." *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 n.7 (1992). A state tax violates the Commerce Clause unless it provides a mechanism to mitigate the risk of

duplicative taxation on income earned from interstate commerce. *Complete Auto Transit Inc. v. Brady*, 480 U.S. 274, 269 (1977). Such a risk, by itself, contravenes this constitutional restriction on state power. *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434, 439 (1939) ("The present tax, though nominally local, thus in its practical operation discriminates against interstate commerce, since it imposes upon it, merely because interstate commerce is being done, the risk of a multiple burden to which local commerce is not exposed."). *See also Freeman v. Hewitt*, 329 U.S. 249, 256 (1946) ("The immunities implicit in the Commerce Clause and the potential taxing power of a State can hardly be made to depend, in the world of practical affairs, on the shifting incidence of the varying tax laws of the various States at a particular moment.").

The income at issue in this case is solely business income generated from operation of Maxim's interstate business, and the prohibited risk of multiple taxation of that income has become a reality. Maxim is treated as an S corporation for both federal and Maryland income tax purposes. While S corporations are not generally subject to tax, their shareholders must include their pro rata share of the income, loss, deductions, and credits generated by the S corporation when computing their personal income tax liabilities. In addition to reporting their pro rata share of these tax items in their individual returns, the character of the items in the hands of the S corporation carries over to the shareholders as if the shareholders

had generated them in the first instance. 26 U.S.C. § 1366(b).[5]

Maryland has adopted the federal treatment of S corporations for purposes of its own tax system. "To the extent practicable, the Comptroller shall apply the administrative and judicial interpretations of the federal income tax law to the administration of the income tax laws of this State." Md. Code Ann., Tax-Gen. § 10-107. Thus, an individual taxpayer in Maryland must include his or her pro rata share of S corporation income in his or her Maryland individual income tax computation, and the character of that income is the same in the hands of the individual taxpayer as it was in the hands of the S corporation. 26 U.S.C. § 1366(b).

The county portion of the Maryland individual income tax at issue in this case is being assessed against the Wynnes' pro rata share of Maxim's items of income, loss, deduction, and credit that flow directly to their Maryland income tax return and are subject to tax at the shareholder level. This income, which was undeniably generated in interstate commerce, retains its character even though taxed on the Wynnes' Maryland individual income tax return. The substance of the tax is a tax on the commercial income of Maxim, albeit reported by and taxed against the Wynnes.

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[5] "The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) [*i.e.*, the S-corporation's income or loss] shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation."

Overturning the decision of the court below would cast doubt on the continuing applicability of the long line of cases supporting the need for a mechanism to mitigate cascading state taxation on income earned by interstate businesses. Degrading existing Commerce Clause protections would expose interstate commerce to the "danger of . . . being smothered by cumulative taxes of several states" that existed when the first multistate businesses entered the American economy well over a century ago. *Complete Auto Transit Inc. v. Brady*, 330 So.2d 268, 272 (1976). This Court should not make a ruling that calls these principles into question.

## II. The Commerce Clause Prohibition on States Taxing Value Earned Outside Their Borders Requires Allocation in Full for Nonbusiness Income.

Certain income generated by a business is so divorced from the company's general business operations that the Constitution requires it to be excluded from the apportionable tax base and allocated in full to a single State. *See Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 780 (1992) (holding that a sale of stock in a subsidiary was nonbusiness income allocable in full to the State of commercial domicile); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982) (dividends, interest, and capital gains from subsidiaries found to be nonbusiness income allocable to State of commercial domicile). That income, commonly referred to as nonbusiness income, is allocated in full to a corporation's State of commercial domicile (or in the case of real estate, to the State in which the real property is located). But the requirement to allocate nonbusiness income to a single State is itself a form of

Commerce Clause protection because it results in that income being taxed by only a single State—the State of the corporation's domicile (or situs of real property).

*Amicus* the Multistate Tax Commission posits that the income generated by Maxim in the active conduct of its business is transformed into investment income when it passes through to its S corporation shareholders. Br. 4, 10, 11. The income generated by Maxim in this case is not nonbusiness income. It arose from Maxim's operation of an active multistate business that provides healthcare and wellness services across the Nation. By virtue of Maryland law and its adoption of the federal treatment of S corporations, the character of Maxim's income did not change as it passed through to the Wynnes. It remains income from the active conduct of a multistate business and must be treated accordingly for purposes of analyzing the Commerce Clause limitations on Maryland's power to tax.

The holding of the court below does not alter the rules applicable to nonbusiness income. The income Maryland seeks to tax in this case is limited to income generated by a multistate business that was subject to tax in multiple States. Business taxpayers have long relied on these decades' old precedents to guard against extraterritorial taxation that constitutes an "unreasonable clog on the mobility of commerce." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935). Reversing the decision of the court below would upend those Commerce Clause protections, creating substantial uncertainty that would cause businesses with multistate operations to suffer heightened costs and burdens of compliance and to be at risk of cascading taxation.

## CONCLUSION

For the foregoing reasons, as well those in Respondent's brief, the decision below should be upheld.

Respectfully submitted,

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