Discriminatory Taxation and Internal Consistency After Comptroller of the Treasury of Maryland v. Brian Wynne et ux.

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This article discusses discriminatory state taxation, the internal consistency test, and related matters under the dormant Commerce Clause doctrine in the aftermath of Comptroller of the Treasury of Maryland v. Brian Wynne et ux., 135 S.Ct. 1787 (2015). Wynne presents a substantial judicial paradigm noticeably changing the grounds for legal controversy in all situations to which its rationale is arguably applicable: whether the challenged state tax scheme is discriminatory against interstate commerce after taking into account the economic concept of competitive neutrality. The necessary fact patterns are those that present at least the risk of multiple taxation on one group of state taxpayers compared to some other group of state taxpayers.¹ The Wynne rationale applies to all kinds of state taxes or imposts regardless of legislative labels.

¹ Professors Knoll and Mason define “competitive neutrality” in What is Tax Discrimination? 121 Yale L.J. 1014 (2012). A state’s tax scheme is competitively neutral as applicable to labor if, isolating the scheme for market responses to it, it is not possible for labor to increase interstate productivity by people shifting jobs among state jurisdictions, and as applicable to owners of capital (e.g., S corporation shareholders), if, again isolating the scheme for market responses to it, it is not possible for such owners to increase interstate productivity by shifting capital among state jurisdictions. The authors demonstrate that violations of competitive neutrality occur when a state tax scheme has non-uniform source base taxes or non-uniform residence base taxes. Residence taxes are non-uniform if they do not apply on the same basis to all residents no matter the source of their incomes. Source taxes are non-uniform if they do not apply on the same basis to all persons within the jurisdiction of the state’s taxing power, both residents and non-residents.
Within this fundamental context the accountants will grapple with the correct tax adjustments. The fact pattern of an accountant first computing the amount of a state or political subdivision tax refund claim or the amount of taxes to be paid with the state or political subdivision tax return (based upon a return position) will be the sine qua non of future cases. Otherwise, the dormant Commerce Clause doctrine and the internal consistency test would be of purely academic interest both to taxpayers and to state legislatures and revenue agencies.

Meanwhile, Wynne should be viewed by tax attorneys as the bellwether decision sharpening, deepening and broadening the limitations of the dormant Commerce Clause doctrine on state taxation of interstate commerce. It should turn out to be a seminal Supreme Court tax case, like Eisner v. Macomber, 252 U.S. 189 (1920) (explicated the concept of realization as the basis of imposition of federal income taxes). But for the rationale of Wynne, there would not be much to write about. Following internal consistency test precedent the case was a proverbial “open and shut” case as the opinion plainly shows. However, understanding the import of the rationale makes for a worthwhile article. The case facts are but an example of the application of the underlying economic concept of competitive neutrality, as well as a straightforward application of the internal consistency test.

Before Wynne the internal consistency test had been formulated by the Supreme Court as follows: would the adoption by every other state of the same tax scheme as the tax scheme of the state being challenged result in a taxation burden to persons involved in interstate commerce that persons involved only in intrastate commerce (in the challenged state) would not similarly bear? This formulation still stands. There follows an example cited by the Wynne Court.

The facts in Armco Inc. v. Hardesty, 467 U.S. 638 (1984) were Armco, Inc. manufactured in Ohio and sold its product at wholesale in West Virginia and other states. It contested a West Virginia gross receipts tax scheme that imposed a .27% tax on the gross sale prices of wholesale sales of tangible personal property within West Virginia, like some of Armco’s sales. The .27% tax applied to both residents and non-residents selling at wholesale in West Virginia. But, West Virginia manufacturing resident companies were exempted per se. Another aspect of the tax scheme imposed an .88% tax on the selling price of tangible personal property manufactured in West Virginia by resident companies and sold in or out of the state.

Over state objections no tax discrimination could possibly have taken place because the more intrastate focused .88% gross receipts tax far exceeded the deliberately cross border .27% tax, the Court applied the internal consistency test, hypothesizing that had Ohio (and other states) had the same tax scheme intrastate sellers would always pay .88% while interstate sellers would pay 1.15%. When combined with a .27% tax on cross-border sales, a .88% tax on goods manufactured in state and sold out of state makes the tax burden on interstate commerce 1.15%. Meanwhile, tangible property manufactured and wholesaled solely within the state would be taxed at the lower .88%. owing to the resident manufacturers exemption. The Court quoted its precedent that a state tax scheme “… must have what might be called internal consistency—that is the [tax scheme] must be such that

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2 “Our existing dormant Commerce Clause cases all but dictate the result reached in this case by Maryland’s highest court.” Wynne, supra, 135 S.Ct. at 1794.

if applied by every jurisdiction there would be no impermissible interference with free trade”.

The Wynne Court several times cites *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978). There the Court acknowledged that Iowa’s switch to a then unusual sales only, single factor income allocation formula might have resulted in some double taxation to the taxpayer, viz. favor Iowa intrastate businesses over Moorman Mfg. which was an interstate business corporation. For want of proof as to the “overlap” of Illinois and Iowa corporate income taxes on Moorman Mfg.’s *net income* by a demonstration of what portion of *net income* from Illinois sales being taxed in Illinois under its three factor formula also was being allocated to Iowa under its new single factor formula, the Court did not discuss the internal inconsistency test. It was, moreover, unwilling to hold Iowa’s single factor violated the commerce clause as discriminatory against interstate commerce on a number of alternative grounds. Ultimately, the Court stated the Commerce Clause does not require the Court to fashion a uniform income allocation formula binding on all states imposing income taxes on corporations in order to eliminate risk of double taxation.

The Wynne rationale bothers with *Moorman Mfg. Co.* likely because in retrospect it’s evident Iowa’s single factor income allocation formula had been internally consistent. It applied to in-state corporations with in-state sales only, in-state corporations with in and out of state sales and out of state corporations with Iowa sales as well as home state and other state sales, and presumably uniform income tax brackets. In light of the Privileges and Immunity Clause of Article IV of the Constitution, I venture the further assumption the same corporate net income tax base applied across the board under Iowa’s corporate income tax scheme. If every state had it, all three classes of corporate taxpayers would be treated the same tax wise by all the states without multiple taxation.

By the time of *Wynne*, most everybody believed the internal consistency test had nothing to do with a comparative analysis of the tax scheme of the state being challenged to the tax scheme of one or more other states where a petitioner was also paying a similar tax on all or a part of the same or substantially the same taxation base, whether for example based upon number of truck axles or “income” in all various forms. This almost consensus emerged after cases like *Moorman Mfg. Co.* Yet *Wynne* was in part the result of a widespread perception that the internal consistency test had to do with a comparative analysis of the at least two state tax schemes that had interacted to cause the taxpayer double taxation and hence to file an administrative appeal and lawsuit. Literally following the tax returns’ trails, that was the case. There was misunderstanding because the subject matter is complex.

Disagreements should continue after *Wynne* on a case-by-case basis because the subject matter is complex. For example, pass-through entity state taxation schemes are increasingly substituting a “withholding tax” on the pass-through entity instead of a direct personal income tax on the out-of-state owners. Also, the competitive neutrality economic concept embraced by the Court in *Wynne* is difficult. And, why should businesses and individuals be paying multiple or risk paying multiple taxes, the degree of which is correlated to the depth and breadth of a taxpayer’s professional tax resources, to multiple jurisdictions on the same dollar of gross or net income or asset value or asset use or other tax base touching multiple non-federal taxing jurisdictions especially now that *Wynne* is the bellwether?

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4 In fact, the switch resulted in a far greater portion of Moorman Mfg.’s corporate taxable income being allocated to Iowa than under Iowa’s previous, typical three-factor formula.


6 The Comptroller and U.S. Solicitor General didn’t see any inconsistency, not to mention “internal inconsistency”, in Maryland’s tax scheme. “ . . . Maryland’s tax is neutral . . . ” *Wynne*, supra, 135 S.Ct. at 1804.
Wynne employs the Brief of the Tax Economists as amici curiae focusing on the manner in which professional economists analyze market responses to state personal income taxes based upon a widely accepted free trade model of market responses to tariffs. The internal consistency test as applied by the Court to the Maryland tax scheme fits together with the brief’s analysis. The foregoing proposition is not self-evident, but is critical to understanding the Wynne rationale and, therefore, needs to be illustrated as per the brief.7

State A imposes a 20% tariff upon the import of widgets coming from State B residents. The economic presumption is that the prices for widgets will have to rise in State A in order to preserve unchanged the incentives of buyers and sellers in State A and State B to engage in interstate commerce: State B does not have a tariff, so State B sellers can earn $100 by selling $100 worth of widgets to State B residents; but in order to earn the same $100 post-20% tariff by selling to State A residents State B sellers would have to sell the same quantity of widgets for $125 (80% of $125=$100). However, a price rise would cause State A residents to sell exclusively in State A where they would earn $125 (because the State A sellers are not subject to the tariff) and not sell to State B buyers where prices are only $100. On the other hand, if prices do not rise to $125 in State A, then State B sellers will not sell into State A, but sell to State B residents, as aforesaid. Plainly, the State A tariff places interstate commerce involving states A and B in a discriminated against position relative to State A intrastate commerce. The brief points out, and the Court emphasizes but without explanation, the Maryland’s tax scheme operated like the illustrated State A tariff. Here is how.

Maryland’s up to 6% tax rate on income earned by non-residents from Maryland sources, plus the up to 7.95% tax rate on residents’ incomes from out-of-state sources operates in the same economic way as the illustrated tariff insofar as these 13.95% combined taxes on interstate commerce exceed the only up to 7.95% tax rate Maryland imposes on residents’ incomes from intrastate commerce. This “discriminatory” tax scheme has to have effects on free trade prices like the discriminatory 20% rate tariff on goods crossing the State A line compared to the 0% rate or no tariff on goods not crossing over from State B. The Court accepted this economic comparison and that is significant as a matter of legal precedent. A state tax scheme that has the economic effects of a tariff, is “is the paradigmatic example of a law discriminating against interstate commerce.”8 The tax scheme, “…has the same economic effect as a state tariff, the quintessential evil targeted by the dormant Commerce Clause.”9

The Economists amici curiae brief further points out that the internal consistency test is an economically logical and practical means to measure whether a state’s tax scheme discriminates against interstate commerce, because the test can compare the tax burden on intrastate transactions to the tax burden on both transactions involving residents’ out-of-state activities and non-residents activities within the state. When applied to a challenged tax regime, the key idea (and as best articulated) is if it were copied by every state then each interstate transaction will be taxed as an inbound transaction in one state and an outbound transaction in another state. Hence Maryland’s 13.95% combined tax rates on interstate commerce is inconsistent with Maryland’s 7.95% purely intrastate commerce tax rate. The Maryland tax scheme is “internally” inconsistent. That the Wynnes also paid personal income taxes to other states because these states taxed non-

7 The internal consistency test turns out to be a heuristic methodology for the economic analysis in both economics focused amici curiae briefs that were embraced by the Court.
8 Wynne, supra, 135 S.Ct. at 1804
9 Id. at 1792.