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Mark Snider
614.227.2150
msnider@porterwright.com

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Supreme Court says give credit where credit is due

Facts of the case:

In *Comptroller of Treasury of Maryland v. Wynne*, 135 U.S. 1787 (2015), a married couple residing in Maryland alleged that Maryland's county tax on their personal out-of-state income was unconstitutional. The taxpayers received pass-through income from a Subchapter S corporation that filed income tax returns in 39 states. Maryland's tax laws gave the taxpayers a credit for taxes paid to other states against their Maryland state income tax, but did not provide a credit against their county income tax. Thus, the taxpayers were double taxed on their out-of-state income, whereas a resident who earned the same amount of income in-state would not have been subject to the same tax burden. The Court held that the double taxation scheme was unconstitutional because it discouraged interstate commerce in violation of the Dormant Commerce Clause of the U.S. Constitution.

Issues and results:

In a 5-4 decision, the Supreme Court held that the Maryland county tax was a "state tax" because it was administered and collected by the State Comptroller of the Treasury. The Court concluded the county tax was really a state tax operating under another name. Therefore, because the county tax, as a true state tax, discriminated against interstate commerce, the Court held that Maryland's income tax scheme was unconstitutional.

Does the Dormant Commerce Clause apply?

The Court's majority and dissenting opinions debated both the existence and application of the Dormant Commerce Clause. The Commerce Clause gives Congress power to regulate commerce between the states. The Supreme Court has historically interpreted the Commerce Clause to mean that states are precluded from discriminating between in- and out-of-state transactions, including through their taxation systems. Therefore, according to the majority, *Wynne* follows those precedents.

All three dissenting opinions argued, however, that *if* the Dormant Commerce Clause exists at all, the majority applied it improperly to the county tax. Because states are given authority under the Due Process Clause[1] to tax all the income of its residents, even income generated out-of-state, the dissenting opinions argued the Dormant Commerce Clause could not restrict that authority.

Does the tax scheme violate the Dormant Commerce Clause?

The Court applied two central tests to determine whether Maryland's tax scheme violated the Dormant Commerce Clause. In order to be valid, a tax must be "internally consistent" and "externally consistent." A tax is "internally consistent" if, in the hypothetical event all 50 states adopted the same tax scheme, *intra*state commerce would not be favored over *inter*state commerce. Maryland's tax scheme failed this test because out-of-state income was subject to a higher tax burden than in-state income, creating economic incentives that discouraged interstate commerce.

For example, the married couple in *Wynne* paid out of state taxes, whatever percentage of the Maryland state taxes that was left unpaid after the credit was applied and Maryland county taxes on their personal income, simply because that income was generated out-of-state.

A hypothetical couple earning income only in-state would have paid only Maryland state taxes and Maryland county taxes on that income.

The Court was careful not to focus on the *amount* of taxes actually collected in determining what constitutes a higher tax burden.[2] The "critical point" was that the tax scheme created a possibility for double taxation that discriminated against interstate commerce.[3] By removing the possibility for double taxation, Maryland could remedy the internal consistency fault in its tax scheme; however, the court did not foreclose that there may have been other ways to resolve the constitutional fault.[4]

A tax is "externally consistent" if it fairly apportions the amount taxed based on the income's relation to in-state activity. Maryland's tax scheme failed this test because the county tax created a risk of double taxation on out-of-state income that in-state income was not exposed to,[5] and did not credit or account for the taxes already paid in the state where the income was generated.

Maryland's tax scheme violated the Dormant Commerce Clause by discriminating against interstate commerce because it imposed a higher tax burden on out-of-state income than on in-state income. *Wynne* stands for the premise that tax schemes imposing higher tax burdens on income generated out-of-state, without providing a credit or apportionment option for taxes already paid in those states, can be unconstitutional by failing either the internal or external consistency test.

What *Wynne* could mean for Ohio:

The Ohio state personal income tax system already provides a full credit for income subject to taxes in another state. (R.C. 5747.05(B)). However, Ohio municipal income tax law does not guarantee a full credit for income subject to taxes in multiple municipalities. Each municipality is authorized to enact its own city ordinance in which it may define if and what amount of a credit will be given to individuals paying multiple municipal taxes on personal income. For example, Bexley, Ohio does not provide a full credit for income taxes paid in another municipality, while Alliance, Ohio does. (Bexley Tax Ordinances 880.14; Alliance Codified Ordinances 181.14).

In light of *Wynne*, could Ohio residents who do not receive full credits for income subject to multiple municipal tax rates have a constitutional claim under the Dormant Commerce Clause? The Maryland county tax in *Wynne* did not provide a credit for income taxed out-of-*state*. The question for Ohio residents is whether the Dormant Commerce Clause would also prohibit taxes that do not provide a credit for income taxed out-of-*city*.

The Dormant Commerce Clause arguably only prohibits discrimination with respect to inter*state* commerce, not inter*city* commerce. The Commerce Clause gives Congress the authority to regulate commerce between states, not between cities within a state. Therefore, in order for Ohio residents to have a constitutional claim under *Wynne*, the city tax probably must either be a state tax operating under a different name, or discriminate against interstate commerce as a city tax.

Are Ohio municipal taxes just state taxes under a different name?

The Supreme Court characterized Maryland's county tax as a state tax in order to find the tax unconstitutional. The Maryland State Comptroller of the Treasury administered and collected both the county and state tax. For this reason, the Court was unpersuaded that the county tax was anything other than a state tax by another name.

In Ohio, however, each municipality administers and collects its own city taxes or joins with other cities for regional collection.[6] For example, municipal taxes in Alliance, Ohio are administered and collected by an income tax administrator, and those

funds are allocated to specific areas in the city's ordinance. (Codified Ordinances of the City of Alliance, Title 181.06, 181.13). Therefore, Ohio's city tax scheme is arguably not like Maryland's county tax scheme, and Ohio residents forced to pay more than one municipal tax on personal income may not have a claim under *Wynne* on grounds that the city tax is merely a state tax by another name.

Does the Ohio municipal tax scheme discriminate against interstate commerce?

Ohio residents could have a claim under *Wynne* if the Ohio city tax scheme discriminates against interstate commerce. Prospective plaintiffs would have to show that making in-state income subject to double taxation, while only taxing out-of-state income once, discourages interstate commerce. The challenge in making a claim on these grounds is that Ohio's city tax scheme actually might encourage interstate commerce *over* intrastate commerce. Residents making income out-of-state are only subject to Ohio municipal tax in the place where they live; residents making income in-state are subject to double taxation, taxed by the Ohio municipality in which they live and in which they work.

In any event, under *Wynne* the argument would have to clear the additional hurdle of proving the tax scheme "inherently discriminates" against interstate commerce, and is not just creating "disparate incentives" that are the result of nondiscriminatory laws that happen to cause double taxation.[7]

It is unclear from *Wynne* what kind of tax structure would create double taxation without inherently discriminating against interstate commerce. However, since Ohio municipal taxes do not directly double tax out-of-state income and discourage interstate commerce in a direct way, Ohio may have avoided a constitutional flaw in its tax scheme. If the Ohio city tax scheme only creates "disparate incentives," then it may be constitutional under *Wynne* despite the fact that it double taxes in-state income.

Other constitutional arguments

The obvious question Ohio residents will want to ask in wake of *Wynne* is simple: If the *state* is not allowed to double tax out-of-state income, why can the *city* double tax out-of-city income? The state is often thought of as the source of municipal authority. Therefore, it seems counter-intuitive that the superior authority is prohibited from taxing in the same manner in which its subordinate continues to tax. Are there any legal arguments to support these notions of incongruity and unfairness?

Ohio Supreme Court precedent to overcome

In *Thompson v. City of Cincinnati*, the Ohio Supreme Court explicitly asked the same question Ohio residents will want to ask now in wake of *Wynne*: "Can the City of Loveland levy an income tax on the wages of a resident, where such wages result from employment within another municipality and are subject to an income tax in that other municipality?"[8]

The Ohio Supreme Court decided Loveland *did* have the authority to tax income of its residents already taxed in another municipality. The court held that Loveland's municipal taxing power was "restricted only by the General Assembly and not by the actions of other municipalities."[9] Therefore, Ohio residents wanting to overcome this past precedent will need to argue that the law has since changed, making Ohio's municipal tax scheme no longer constitutional.

Due Process

The Due Process Clause provides that no state "[shall] deprive any person of life, liberty, or property, without due process of law."[10] A state must have a connection to the person and transaction it wishes to tax, as well as a rational relationship between the tax and the state's values with respect to taxing purposes.[11] For example, in *Hillenmeyer v. Cleveland Board of Review*, the Ohio Supreme Court held that Cleveland's power to tax non-resident income "reache[d] only that portion of a non-resident's compensation that was earned by work performed in Cleveland."[12]

For an Ohio resident living in one city and working in another, then, it seems neither city likely violates Due Process rights by taxing income subject to tax in another municipality. By living and working in either city, a resident establishes a connection to both municipalities. Likely both cities could provide valid reasons to tax both residents and the non-resident workforce. In fact, the Ohio Supreme Court has already decided that cities have the authority to tax non-resident income because the city provides "protection against fire, theft, et cetera, to the place of business of plaintiff's employer and the operation thereof without which plaintiff's employer could not as readily run its business and employ help."[13]

Full Faith and Credit

Full Faith and Credit provides that "records and judicial proceedings … shall have the same full faith and credit in every court within the United States and its Territories and Possessions as they have by law or usage in the courts of such State, Territory or Possession from which they are taken." (28 USCA 1738). For example, if a couple is legally divorced in Indiana, Ohio must recognize that divorce.

Note, however, that Full Faith and Credit only applies to courts of any state, territory, or possession; it does not include the Supreme Court. However, it seems that if Ohio state courts are required to honor the judicial proceedings of an Indiana state court, then should those courts not also respect the proceedings of the Supreme Court? The spirit of Full Faith and Credit would suggest that if state governments are prohibited from double taxing out-of-state income, local governments should follow suit with respect to out-of-city income. The only difference between the two scenarios is that state lines are replaced by city limits. Though the Supreme Court may not have direct jurisdiction under the Commerce Clause over local governments affecting commerce fully within a state's borders, surely its precedent for double taxation on the basis of non-residency is to be respected by municipal governments anyway.

Privileges and Immunities

Under the Privileges and Immunities Clause, "[t]he Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States." The Supreme Court has previously held in a New Jersey case that municipal ordinances are within the scope of the Privileges and Immunities Clause.[14] However, in the same case the Court decided that while out-of-state residents may have a claim under the Privileges and Immunities Clause against city ordinances that put them at a disadvantage as compared to city residents, state residents not residing in the city "have no claim under the Privileges and Immunities Clause."[15] The Court reasoned that "New Jersey residents at least have a chance to remedy at the polls any discrimination against them. Out-of-state citizens have no similar opportunity, and they must 'not be restricted to the uncertain remedies afforded by diplomatic processes and official retaliation.'"[16]

Importantly, the municipal ordinance in Camden, New Jersey "would not have gone into effect without express approval by the state treasurer."[17] All in-state residents, then, would have had an opportunity to influence the enactment of such a city ordinance at the polls. The same is not true in Ohio.

The Ohio state government gives each city the right to enact their own ordinance, provisions of which include its tax provisions. The "legislative authority of the municipal corporation" adopts or amends the ordinance that levies the tax, not a state body. (R.C. 718.04). Only the "electors of such [a] municipality" vote on whether a municipal corporation will levy a tax. (R.C. 718.01). Therefore, residents living outside a municipality do not have recourse at the polls to influence the city's tax scheme.

Would it be possible, then, for an Ohio resident to bring a Privileges and Immunities Claim against the municipal tax in the city in which they work? Perhaps it is possible, as the argument would sound awfully reminiscent of "taxation without representation."

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For more information please contact Mark Snider or any member of Porter Wright's Tax Practice Group.

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[1] *Comptroller of Treasury of Maryland v. Wynne*, 135 S. Ct. 1787, 1791 (2015) ("Maryland's tax scheme is not immune from dormant Commerce Clause scrutiny simply because Maryland has the jurisdictional power under the Due Process Clause to impose the tax.").

[2] *Id.* at 1805 ("The critical point is that the total tax burden on interstate commerce is higher, not that Maryland may receive more or less tax revenue from a particular taxpayer.").

[3] *Id.*

[4] *Id.* at 1806 ("[W]hile Maryland could cure the problem with its current system by granting a credit for taxes paid to other States, wet does not foreclose the possibility that it could comply with the Commerce Clause in some other way.")

[5] *Wynne*, 135 S. Ct. at 1793 ("If these receipts were also taxed by the States in which the sales occurred, we warned, interstate commerce would be subjected 'to the risk of a double tax burden to which intrastate commerce is not exposed, and which the commerce clause forbids.'") See also *id.* at 1793 ("This tax, we wrote, '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.'"); *Id.* at 1804 ("For example, in *Armco*, we struck down an internally inconsistent tax that posed a risk of double taxation even though we recognized that there might be other permissible arrangements that would result in double taxation."); *Id.* at 1816 ("States confront the same trade-off when deciding whether to tax nonresidents' entire in-state income. A State can require all residents and nonresidents who work within the State under its protection to contribute equally to the cost of that protection. Or the State can seek to avoid exposing its workers to any risk of double taxation." "Conversely, the Court prioritizes reducing the risk that the Wynnes' income will be taxed twice by two different States."). But see *id.* at 1820 (Ginsburg, J., dissenting) ("Abandoning principles and precedent sustaining simultaneous residence- and source-based income taxation, the Court offers two reasons for striking down Maryland's county income tax: (1) the tax creates a risk of double taxation," "and (2) the Court deems Maryland's income tax 'scheme' 'inherently discriminatory'—by which the Court means, the scheme fails the so-called 'internal consistency' test[.]" The first objection is overwhelmed by the history, recounted above, of States imposing and this Court upholding income taxes that carried a similar risk of double taxation." "The Court's reliance on the internal consistency test is no more compelling.")

[6] REGIONAL INCOME TAX AGENCY, ritaohio.com (last visited June 11, 2015).

[7] *Id.* at 1802 ("By hypothetically assuming that every State has the same tax structure, the internal consistency test allows courts to isolate the effect of a defendant State's tax scheme. This is a virtue of the test because it allows courts to distinguish between (1) tax schemes that inherently discriminate against interstate commerce without regard to the tax policies of other States, and (2) tax schemes that create disparate incentives to engage in interstate commerce (and sometimes result in double taxation) only as a result of the interaction of two different but nondiscriminatory and internally consistent schemes." "The first category of taxes is typically unconstitutional; the second is not." "Tax schemes that fail the internal consistency test will fall into the first category, not the second: '[A]ny cross-border tax disadvantage that remains after application of the [test] cannot be due to tax disparities'6 but is instead attributable to the taxing State's discriminatory policies alone.'").

[8] *Thompson v. City of Cincinnati*, 2 Ohio St. 2d 292, 294 (1965).

[9] *Id.* at 295.

[10] *Hillenmeyer v. Cleveland Bd. of Rev.*, 2015-Ohio-1623, 2015 WL 1934760, at *8 (Apr. 30, 2015).

[11] Id.

[12] *Id.*

[13] *Angell v. City of Toledo*, 153 Ohio St. 179, 185 N.E.2d 250 (1950).

[14] *United Bldg. & Const. Trades Council of Camden Cnty. & Vicinity v. Mayor & Council of City of Camden*, 465 U.S. 208, 212 (1984) ("The first argument can be quickly rejected. The fact that the ordinance in question is a municipal, rather than a state, law does not somehow place it outside the scope of the Privileges and Immunities Clause.")

[15] *Id.* at 217

[16] *Id.*

[17] *Id.* at 214.