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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 Maryland Court of Appeals

BRIEF OF THE TAX ECONOMISTS AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Whether Maryland's decision to offer only a partial credit instead of a full credit to residents for taxes paid to other jurisdictions unconstitutionally discriminates against interstate commerce where the state has chosen to impose comparable tax burdens on income earned by residents within the state, by residents outside the state *and* by nonresidents within the state?

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INTEREST OF *AMICI CURIAE*[1]

Amici are scholars who specialize in the economic analysis of tax law and tax policy. *Amici* respectfully urge this Court to affirm the decision of the Maryland Court of Appeals. Standard conceptual tools familiar to economic analysis demonstrate that Maryland's income tax scheme does indeed discriminate against interstate commerce, although for different reasons than identified by the Court below. The discrimination does not stem from the risk that Maryland's tax could combine with the tax of some other jurisdiction so as to tax the same income twice. It stems instead from Maryland's decision to tax the income earned by residents within the state, residents outside the state and nonresidents within the state at comparable rates. The state's offer of a partial credit for taxes paid to other jurisdictions is insufficient to remedy the resulting inherent discrimination against interstate commerce.

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[1] Petitioner and Respondents have filed with the Clerk of the Court letters granting blanket consent to the filing of *amicus curiae* briefs. Pursuant to Rule 37.6, *amici* affirm that no counsel for a party authored this brief in whole or in part, and no person or entity other than *amici* or their counsel made a monetary contribution to its preparation or submission.

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SUMMARY OF ARGUMENT

The Maryland income tax scheme at issue here is as discriminatory as any tariff. Its discriminatory nature does not arise, as the Maryland Court of Appeals reasoned, from the risk that it may combine with some other state's tax system to tax the same income twice. Rather, like an import or export tariff, Maryland's income tax scheme is discriminatory in and of itself because it systematically imposes tax burdens on interstate economic activity that are greater than the burdens imposed on economic activity conducted solely within Maryland. This discriminatory burden exists no matter how other states treat income earned in their jurisdictions.

Maryland has created this discriminatory burden as a result of its decision to tax both income earned by residents outside the state *and* income earned by nonresidents within the state at a comparable rate to the tax it imposes on income earned by residents within the state. In the terminology of cross-border tax policy, Maryland's tax on income earned by nonresidents within the state and the tax on income

earned by residents outside the state constitute taxes on "inbound transactions" and "outbound transactions," respectively. Taxes on such inbound and outbound transactions do not create separate and unrelated burdens on interstate commerce. On the contrary, because interstate commerce flows in both directions across state lines, these taxes *combine* to impose a double burden on cross-border activity. Incentives to engage in interstate commerce are unavoidably impaired when the combined tax burden on inbound and outbound transactions exceeds the tax burden on purely within-state transactions.

States have a wide range of options in designing tax schemes that would avoid such discriminatory impairment and that would be truly neutral as to interstate commerce. For example, states could tax only the income of residents wherever earned, or they could tax only income earned within the state, whether by residents or nonresidents. States could also tax both inbound and outbound transactions, as long as the combined tax burden does not exceed the tax on within-state transactions.

Most states, of course, do not have neutral income tax regimes because they tax inbound, outbound and within-state transactions at comparable rates. It is a near-universal practice, however, for such states to grant full credits to residents for taxes paid to other jurisdictions on their out-of-state income. While such an arrangement is not truly neutral, it has the advantage of mitigating the discrimination inherent in taxing inbound transactions, outbound transactions and transactions within the state at comparable rates. Indeed, a full credit eliminates the double burden on

cross-border activity whenever another state has an equal or higher tax rate. In contrast, however, a partial-credit scheme such as Maryland's *never* eliminates the double tax burden on interstate activity, regardless of other states' tax rates. Therefore, Maryland's decision under a 1975 amendment to its tax code to abandon its full credit for taxes paid to other jurisdictions has resulted in a tax scheme under which interstate commerce is always disadvantaged relative to within-state commerce.

Although the Maryland Court of Appeals misidentified the source of the discrimination by focusing on the risk of two states taxing the same income, it reached the correct substantive result by, among other things, applying this Court's well-established internal consistency test. Pet. App. at 19-23. As this Court has previously held, the internal consistency test can be used as a gauge of whether a given state's tax regime discriminates against interstate commerce and not simply as a measure of whether a state's tax burden is fairly apportioned among competing jurisdictions. The internal consistency test succeeds as a substantive indicator of such discrimination because it correctly measures the combined tax burden on inbound and outbound transactions and compares it to the tax burden on within-state transactions. Maryland's tax scheme violates the internal consistency test because, if every state adopted the same tax scheme, the tax burden on income earned by one state's resident outside the state would always be approximately 1.25 percentage points higher than the tax burden on income earned by a resident within the state. The Maryland Court of Appeals was therefore correct to strike down

Maryland's partial-credit scheme under the internal consistency test.

Maryland's partial-credit scheme also may be struck down as facially discriminatory. Maryland eliminated its full credit by enacting legislation in 1975 that increased the tax burden on cross-border activity—and cross-border activity alone—by restricting the potential scope of the credit offered for taxes paid to other jurisdictions. It is of no constitutional moment that this increased burden on interstate commerce was carried out through the reduction of a credit rather than through an increased tax rate.

Finally, the Court may reject each of the arguments offered by Petitioner in support of reversal. Contrary to Petitioner's argument, this case does not turn on the question of whether a state may tax all the income of residents wherever earned nor does it raise the question of whether a full credit for taxes paid to another jurisdiction is constitutionally required in all circumstances. There is nothing inherently discriminatory against interstate commerce about taxing residents' income wherever earned, even if it might result in two jurisdictions taxing the same income. However, where a state such as Maryland chooses to tax its residents' income wherever earned *and* the income of nonresidents earned within the state at roughly comparable rates, then it discriminates against interstate commerce. Maryland's partial credit for taxes paid to other jurisdictions falls short of providing a minimally acceptable mitigation of the resulting discrimination.

ARGUMENT

I. MARYLAND'S DECISION TO ELIMINATE THE FULL CREDIT IT ONCE OFFERED FOR TAXES PAID ON INCOME EARNED BY RESIDENTS OUT OF STATE HAS RESULTED IN A TAX SCHEME THAT NECESSARILY DISCRIMINATES AGAINST INTERSTATE COMMERCE.

A. Any Jurisdiction That Taxes Inbound, Outbound And Within-State Transactions At Comparable Rates Discriminates Against Interstate Commerce.

Assessing whether a statute discriminates against interstate commerce is the touchstone of this Court's dormant Commerce Clause jurisprudence. *Wyoming v. Oklahoma*, 502 U.S. 437, 454 (1992) ("It is long established that, while a literal reading evinces a grant of power to Congress, the Commerce Clause also directly limits the power of the States to discriminate against interstate commerce. . . . When a state statute clearly discriminates against interstate commerce, it will be struck down, unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism." (internal citations omitted)); *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977) (noting that a tax will survive scrutiny under the dormant Commerce Clause where the tax's "practical effect," *inter alia*, "does not discriminate against interstate commerce"). By invalidating discriminatory tax schemes, this Court has ensured that a state does not "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). As a result, the Court has helped guarantee that the revenue measures for each taxing jurisdiction "maintain state boundaries as a neutral factor in economic decisionmaking." *Am. Trucking Ass'ns, Inc. v. Scheiner*, 483 U.S. 266, 283 (1987).

Petitioner asserts that Maryland's income tax scheme does not discriminate against interstate commerce because it imposes no greater tax rate on income earned out of state by residents than on income earned within the state by residents and because "residents are taxed evenhandedly on all their income, regardless of its origin." Pet. Br. at 35-36. According to Petitioner, Maryland's offer of a partial credit for taxes paid to other jurisdictions *favors* interstate commerce because it subjects interstate commerce to a lower tax rate than commerce within the state. *Id.* at 37 n.14. Petitioner's analysis, however, is fundamentally mistaken. It fails to consider the critical fact that interstate commerce flows in two directions across state lines. Taxes on income that flows out of the state and taxes on income that flows into the state are not separate and unrelated burdens on interstate commerce. Rather, these two taxes combine to impose a double burden on interstate commerce.[2] As discussed below, the Court's internal

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[2] The need to combine both inbound and outbound transaction taxes to assess how a given system changes incentives to engage in cross-border commercial activity has been discussed in economic and legal literature. *See, e.g.*, Joel Slemrod, Carl Hansen & Roger Procter, *The Seesaw Principle in International Tax Policy*, 65 J. Public Econ. 163 (1997); Ruth Mason & Michael S. Knoll, *What is*

consistency test reflects the need to consider both taxes.

Scholarship on income taxation refers to cross-border transactions that involve income-generating activity by residents outside the taxing state as "outbound transactions" and to cross-border transactions that involve income-generating activity by nonresidents within the state as "inbound transactions." Howard E. Abrams & Richard L. Doernberg, *Essentials of United States Taxation* §§ 29.2, 29.3 (1999). This terminology can be used to describe the two components of Maryland's cross-border tax scheme.

During the relevant 2006 tax year, Maryland imposed a tax on its residents' outbound transactions—*i.e.*, the income that its residents earned outside of the state—at a rate of 6.0 to 7.95 percent. This outbound transaction tax consisted of a state income tax of up to 4.75 percent and a county tax (also collected by the state) ranging from 1.25 to 3.2 percent, depending on the locality. Md. Code Ann., Tax-Gen. §§ 10-102, 10-103(a), 10-105(a), 10-106(a)(1) (2005); Revenue Admin. Div., Comptroller of Md., *State & Local Tax Forms & Instructions for filing personal state and local income taxes for full- or part-year Maryland*

Tax Discrimination?, 121 Yale L.J. 1014 (2012); Ruth Mason & Michael S. Knoll, *A Brief Sur-Reply to Professors Graetz and Warren*, 123 Yale L.J. Online 1 (2013). For a mathematical analysis, *see* Ryan Lirette & Alan D. Viard, *State Taxation of Interstate Commerce and Income Flows: The Economics of Neutrality* (Am. Enter. Inst. Econ. Policy Working Paper No. 2014-07, 2014), *available at* http://www.aei.org/papers/economics/state-taxation-of-interstate-commerce.

residents 10 (2006), *available at* http://forms.maryland taxes.com/06_forms/residentbook.pdf. Maryland also imposed a tax on inbound transactions—*i.e.*, the income earned by nonresidents within the state—at a rate of up to 6.0 percent. This 6.0 percent inbound transaction tax consisted of the 4.75 percent state tax and a 1.25 percent Special Nonresident Tax ("SNRT"). Md. Code Ann., Tax-Gen. §§ 10-102, 10-105(a), 10-106.1 (2005). The SNRT applies to nonresidents in lieu of county income tax, although the county income tax applies to wages earned within a county by nonresidents living in localities that tax Maryland residents' wages. *Id.* §§ 10-103(a)(4), 10-806(c).

At all relevant times, the tax burden that Maryland imposed on cross-border activity therefore included an outbound transaction tax of up to 7.95 percent and an inbound transaction tax of up to 6.0 percent, for a combined total tax burden on cross-border transactions of up to approximately 13.95 percent.[3] The tax imposed on within-state transactions was far lower. It consisted of a state tax at a rate of up to 4.75 percent and a county tax at a rate ranging from 1.25 to 3.2 percent, for a maximum combined tax of 7.95 percent. *Id.* §§ 10-102, 10-103(a), 10-105(a), 10-106(a)(1). Because the combined tax burden on cross-border transactions

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[3] The exact combined burden arising from the 6.0 and 7.95 percent taxes is 13.473 percent. The combined tax burden is computed by adding the two tax rates and subtracting an interaction term equal to the first tax rate multiplied by the second tax rate, which reflects the fact that the second tax is deemed to be paid only on the income that remains after paying the first tax. *See* Lirette & Viard, *supra* note 2, at 10-11, 16, 19. A similar interaction term applies to all of the combined-tax-burden calculations in this brief.

substantially exceeded the 7.95 percent maximum tax on within-state activity, the tax scheme applied to Respondents' income was—and is—inherently discriminatory against interstate commerce. Indeed, the combined tax burden operates in exactly the same manner as any tariff to discourage cross-border activity.

It is important to be clear precisely why tariffs discriminate against interstate commerce while many other taxes do not. Some taxes are neutral as to interstate commerce because prices can adjust in the wake of the tax so as to preserve incentives to transact across state lines relative to incentives to transact solely within the state. In the case of a tariff or other similarly discriminatory tax, however, it is mathematically impossible for prices to adjust following the imposition of the tax so as to leave incentives to engage in interstate commerce unimpaired.

Consider two hypothetical states, A and B. Suppose that State A imposes a 20 percent tariff on the import of widgets costing $100 from State B. Prices for those widgets would have to rise in State A to preserve unchanged the incentives of buyers and sellers in State A and State B to transact among themselves. Because a State-B merchant could always earn $100 by selling a widget to a fellow State-B resident, that merchant's incentive to sell in State A can remain unchanged only if the price of State-A widgets were to rise to $125. At that price, a State-B merchant could recoup the same $100 after paying the 20 percent tariff, *i.e.*, a $25 tariff on a $125 sale. However, if widget prices in State A were to rise to $125, then State-A sellers would have no

incentive to sell their widgets to buyers in State B because they would earn only $100 in that jurisdiction.

State A's 20 percent tariff therefore creates a dilemma. If prices rise to $125 per widget in State A, then interstate commerce suffers because State-A sellers no longer have an incentive to trade with State B. If prices do *not* rise to $125 per widget, then interstate commerce suffers because State-B sellers no longer have an incentive to trade with State A. Either way, the tariff places interstate commerce at a disadvantage as compared to commerce within the state.

Maryland's combined tax on outbound and inbound transactions discriminates against interstate commerce in exactly the same manner as State A's tariff. Although Maryland taxes income-producing opportunities rather than widgets, the same analysis applies when considering whether returns on investment in those opportunities could potentially adjust to preserve incentives to transact across state lines.[4]

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[4] Petitioner claims that it is "hardly a self-evident proposition" that the Court's dormant Commerce Clause jurisprudence applies to individual income taxes rather than taxes on goods. Pet. Br. at 33. From an economic standpoint, however, it is self-evident. Just as the dormant Commerce Clause restricts a state from imposing a protectionist tariff that influences where widgets are sold, it should restrict discriminatory taxation of the income from widget production that would have similar effects. *See Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 404 (1984). Under Petitioner's logic, the Court's dormant Commerce Clause jurisprudence would also not apply to property taxes, a position squarely rejected by the Court in *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 574 (1997) ("A tax on real estate, like *any* other tax,

Suppose that State A taxes (i) income earned by its residents within the state at a 20 percent rate, (ii) income earned by residents outside the state (the outbound transaction tax) at a 20 percent rate, and (iii) income earned by nonresidents within the state (the inbound transaction tax) at a 20 percent rate. Under Petitioner's logic, State A's tax scheme would not discriminate against interstate commerce because it ostensibly treats everyone in exactly the same manner, taxing residents' in-state income at the same rate as nonresidents' in-state income and at the same rate as residents' out-of-state income.

In reality, however, State A's hypothetical tax regime is inherently discriminatory because it necessarily impairs incentives to engage in interstate commerce in the same manner as a tariff. If business opportunities in each state offered a $100 return in the absence of the tax, then the return would have to rise to $125 in State A to preserve unchanged the incentive for State-B residents to engage in interstate commerce with State A. At that return, a State-B resident could pay the 20 percent inbound transaction tax to State A and still receive the same $100 after-tax return the resident could earn by doing business in State B. However, if the return rose to $125, then State-A residents would prefer to do business in their home state rather than in State B. A State-A resident could earn $100 from that investment after paying $25 to meet the 20 percent within-state tax, but would earn only $80 by doing business in State B due to the need to pay the 20 percent outbound transaction tax.

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may impermissibly burden interstate commerce." (emphasis added)).

Contrary to Petitioner's reasoning, State A's tax scheme is not remotely neutral. Like a tariff, the state's taxation of both inbound and outbound transactions creates a dilemma. If the return rises to $125 in State A, then interstate commerce suffers because State-A residents no longer have an incentive to do business in State B. If the return does *not* rise to $125 in State A, then interstate commerce suffers because State-B residents no longer have an incentive to do business in State A. Either way, interstate commerce is placed at a disadvantage as compared to within-state commerce. The fact that the combined burden on interstate transactions exceeds the burden on transactions within the state prevents any possible adjustment from maintaining incentives to engage in interstate commerce.

Like the State-A tax scheme described above, Maryland's tax scheme is inherently discriminatory because it taxes both inbound and outbound transactions at rates comparable to its tax on within-state transactions. Therefore, the question presented in this case is whether a partial credit to residents for taxes paid to other jurisdictions—as opposed to the full credit that Maryland offered prior to the 1975 amendment of its tax code—is an appropriate means to mitigate the discrimination resulting from Maryland's decision to tax inbound, outbound and within-state transactions at comparable rates. As discussed below, it is not.

B. Maryland's Pre-1975 Provision Of A Full Credit On Outbound Transactions, While Not Perfectly Neutral, Mitigated The Discriminatory Burden On Interstate Commerce.

In an ideal world, states would avoid discriminating against interstate commerce by adopting truly neutral income tax regimes. With such neutral tax systems, it is possible for returns to adjust so that there is no incentive to shift from cross-border to purely within-state activity. Although in practical operation, returns may not actually adjust to preserve all incentives intact, neutral tax systems stand in sharp contrast to discriminatory tax regimes by preserving the potential for incentives to engage in cross-border activity to remain unchanged following imposition of the tax.

For example, a 20 percent tax by State A on all income earned within the state—whether by residents or nonresidents—is neutral as to interstate commerce. Economists refer to this tax as a "source-based" tax.[5] *See* A. Lans Bovenberg, *Residence- and Source-based Taxation of Capital Income in an Overlapping Generations Model*, 56 J. Econ. 267, 267-68 (1992).

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[5] If the return rose to $125 in State A, then State-B residents would continue to have the same incentive to do business in State A. After paying the 20 percent source-based tax to State A, a State-B resident would still earn the same $100 after-tax return that could be earned in State B. State-A residents would also earn a $100 after-tax return in State A because they would pay the same $25 source-based tax. Because they could earn the same $100 in State B, State-A residents would have no reason to prefer earning income in State A. Everyone's incentives to engage in cross-border activity would be preserved.

Similarly, a 20 percent tax by State A on the income of residents, wherever such income is earned, is neutral. Economists refer to this tax as a "residence-based" tax.[6] *See id.*

State A could also impose both a 20 percent source-based tax and a 20 percent residence-based tax, as long as residents' income earned within the state is subject to both 20 percent taxes.[7] The even-handedness of such an arrangement follows from the logic of neutrality. The source-based tax is neutral only if it taxes residents' in-state income at the same rate as residents' out-of-state income. The residence-based tax is neutral only if it taxes residents' in-state income at the same rate as nonresidents' in-state income. The combination of the two taxes is therefore neutral only if residents' in-state income is subject to both taxes, not just one of them. For this tax scheme, as with a source-based or

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[6] If the return remained at $100 in State A, then State-A residents would earn an $80 after-tax return after paying State A's 20 percent residence-based tax, whether they did business in State A or State B. State-B residents face no tax from State A and so would earn the same $100 return whether they did business in State A or State B. Everyone's incentives to engage in cross-border activity would be preserved.

[7] Residents' in-state income would then face a 36 percent tax rate, consisting of one 20 percent tax, followed by another 20 percent tax on the remaining 80 percent of income, reflecting the interaction term discussed in note 3, *supra*. If the return rose to $125 in State A, then State-A residents would earn an after-tax return of $80 in either state, paying a $45 tax on a $125 return in State A or a $20 tax on a $100 return in State B. State-B residents would earn an after-tax return of $100 in either state, paying a $25 tax on a $125 return in State A or earning $100 tax-free in State B. Everyone's incentives to engage in cross-border activity would be preserved.

residence-based tax, the combined burden on inbound and outbound transactions equals the tax burden on within-state transactions.

Instead of these neutral tax regimes, many states have adopted Maryland's general scheme of taxing inbound, outbound and within-state transactions at comparable rates, thereby imposing a higher combined tax burden on interstate commerce than on within-state commerce. *See, e.g.*, Walter Hellerstein *et al.*, *State and Local Taxation: Cases and Materials* 397 (9th ed. 2009) (noting that "the states generally tax residents on their income from all sources while taxing nonresidents on income from sources within the state"). In practice, however, states mitigate the combined tax burden on interstate commerce by offering residents a credit for income taxes paid to other jurisdictions. *Id.* States commonly allow credit for the other state's tax up to the amount of the tax on the relevant income imposed by the state granting the credit. *Id.* This widespread "full-credit" approach is not a complete solution to the discrimination against interstate commerce created by a state's decision to tax inbound, outbound and within-state transactions at comparable rates. However, it does provide some relief for such discrimination.

To see how a full-credit scheme mitigates the risk of discrimination, suppose that State A taxes (i) residents' in-state income at 20 percent, (ii) nonresidents' in-state income at 20 percent, and (iii) residents' out-of-state income at 20 percent with a full credit for taxes paid to other jurisdictions on that income. State B taxes all income earned within the state, whether by residents or nonresidents, at a rate equal to or greater than 20

percent. Because State A offers a full credit on taxes paid by its residents on income earned out of state, its effective tax rate on outbound transactions is zero.

With no tax on outbound transactions, State A's tax regime is now identical to a neutral source-based tax scheme that taxes only inbound and within-state transactions, taxing income earned in State A whether by residents or nonresidents. State A's tax regime is neutral because the combined burden on inbound and outbound transactions is only 20 percent, which exactly equals the 20 percent tax burden on transactions within the state. As discussed above, such a tax allows returns to adjust so that everyone's incentives to engage in interstate commerce are unimpaired.

Unlike a pure source-based or residence-based tax, however, a full-credit regime is not neutral in all circumstances. In particular, if State B's income tax rate were lower than State A's 20 percent rate, then State A's regime would remain discriminatory because it would still impose some tax on nonresidents' income from outbound transactions. Indeed, if State B had no income tax, then there would be no reduction whatsoever in State A's combined tax burden on inbound and outbound transactions.

Even though a full-credit regime is not perfectly neutral as to interstate commerce, such an arrangement is a widespread and long-standing means of mitigating the discriminatory burden on interstate commerce that otherwise results from taxing inbound, outbound and within-state transactions at comparable rates. The Court has upheld such full-credit arrangements in the past. *See, e.g., Henneford v. Silas Mason Co.*, 300 U.S. 577, 586-87 (1937) (upholding use

tax on out-of-state property that provided for credit for taxes paid to another jurisdiction in face of a Commerce Clause challenge). However, the fact that a full-credit regime may be constitutionally permissible under the dormant Commerce Clause does not mean that Maryland's partial-credit scheme is similarly permissible. Indeed, the contrast between the two regimes highlights the deficient nature of Maryland's partial-credit scheme. In particular, unlike a full-credit regime, Maryland's partial credit fails to offset the double burden on cross-border transactions resulting from Maryland's taxation of income earned on both inbound and outbound transactions no matter what tax rate another state might have. Maryland's partial-credit scheme is therefore inherently discriminatory in all circumstances.

C. In Contrast To A Full-Credit Regime, Maryland's Current Partial-Credit Scheme Discriminates Against Interstate Commerce In All Circumstances.

Instead of offering a full credit for income taxes paid by its residents to other states, Maryland provides only a partial credit. Residents may generally claim credit against the state portion of Maryland's income tax for taxes paid to other states on income earned in other states. This credit is limited to the increase in Maryland state income tax liability arising from the inclusion of the income earned in and taxed by other states. Md. Code Ann., Tax-Gen. § 10-703(a). The credit is not applicable to the county income tax. *Comptroller v. Blanton*, 390 Md. 528, 541-42 (2006).

Under this partial-credit scheme, the combined tax burden on cross-border activity always exceeds the tax burden on commercial activity that takes place solely within the state, thereby discriminating against interstate commerce in all circumstances. In the relevant 2006 tax year, Maryland taxed within-state transactions at up to 4.75 percent plus the county tax rate. Md. Code Ann., Tax-Gen. §§ 10-105(a), 10-106(a)(1) (2005). It taxed inbound transactions at the 4.75 percent state income tax rate plus the 1.25 percent SNRT, for a maximum combined tax burden of 6.0 percent. *Id.* §§ 10-105(a), 10-106.1. At best, the partial credit for taxes paid to other states could offset the 4.75 percent state tax on outbound transactions. *Id.* § 10-703(a). However, Maryland would still tax outbound transactions at the county rate because no credit applies to that portion of the tax. Under this scheme, the combined tax burden on inbound and outbound income always exceeds the tax burden on income earned by residents within the state by approximately 1.25 percentage points. The burden on outbound transactions would, of course, be even greater if the other state's tax rate were below 4.75 percent.

Because Maryland's combined tax burden on interstate commerce exceeds the burden on within-state commerce, the Maryland tax scheme creates an inherent bias against interstate commerce. Consider a Maryland resident facing a county tax rate of 1.25 percent, and suppose that another state imposes a 10 percent tax rate. The return in Maryland must be *at least* $95.74 to maintain incentives for the other state's residents to do business in Maryland. This is because the other state's resident would pay Maryland's 6.0 percent nonresident tax (where they will pay $5.74 tax

on the $95.74 return and net $90) rather than their home state's 10 percent tax rate. But the return in Maryland must be *no more than* $94.41 to maintain incentives for Maryland residents to do business in the other state. This is because Maryland's residents will pay 11.25 percent tax (10 percent tax to the other state and 1.25 percent county tax to Maryland) rather than Maryland's 6.0 percent tax (where they will pay $5.66 tax on the $94.41 return and net $88.75). There is no possible level of return at which incentives to transact across state lines remain unchanged. The maximum return that will preserve interstate incentives for Maryland residents is $1.33 less than the minimum return needed to preserve interstate incentives for the other state's residents. This resulting discriminatory burden is caused solely by Maryland's tax rather than by the other state's tax and is made even worse if the other state taxes income at a rate below 4.75 percent or imposes no tax at all.

The discriminatory nature of this partial-credit scheme does not depend on what other states may do. Rather, it is inherent in Maryland's own tax treatment of residents' in-state income, residents' out-of-state income and nonresidents' in-state income. If Maryland utilized a truly neutral tax regime, for example, by taxing only the income of residents wherever earned, there would be no constitutional need for a credit of any sort. Because the discrimination is of Maryland's own making, Petitioner's argument that a state should not be constrained from taxing its residents' out-of-state income merely because other states make an independent decision to tax that income is irrelevant. *See* Pet. Br. at 31.

Maryland's partial-credit scheme places a combined burden on cross-border transactions that always exceeds the burden on within-state commerce. It therefore places "burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear." *Jefferson Lines*, 514 U.S. at 180. As a result, the scheme fails to comport with the dormant Commerce Clause.

II. THE COURT'S INTERNAL CONSISTENCY TEST REVEALS THE INHERENTLY DISCRIMINATORY NATURE OF MARYLAND'S TAX SCHEME.

The Court need not develop any new legal rubric to compare the combined tax burden on inbound and outbound transactions against the tax burden on within-state commerce, nor need it employ any analysis of potential price adjustments. The Court can rely on its well-established internal consistency test. The internal consistency test asks whether, if the tax scheme at issue were adopted by all fifty states, interstate commerce would be disadvantaged compared to within-state commerce. *Jefferson Lines*, 514 U.S. at 185. A tax is internally consistent if such hypothetical universal adoption of the tax would impose no greater burden on interstate transactions than that imposed on within-state transactions. *Id.*

The test is not, as Petitioner maintains, merely a means to assess whether a given state's tax is fairly apportioned when several jurisdictions are taxing a unitary, multistate enterprise. *See* Pet. Br. at 38. As this Court has previously held, the internal consistency test also "applies where the allegation is that a tax on its face discriminates against interstate commerce."

Armco Inc. v. Hardesty, 467 U.S. 638, 644 (1984). The internal consistency test is indeed an appropriate and practical means to measure whether a tax scheme discriminates against interstate commerce because it compares the tax burden on within-state transactions to the combined tax burden on both inbound and outbound transactions. If the challenged tax regime were copied by every state, then each interstate transaction would be taxed as an inbound transaction in one state and as an outbound transaction in another state. The "hypothetical" nationwide tax used as the basis for the test is therefore simply the combination of the state's tax on inbound and outbound transactions.[8]

The point is illustrated by the Court's decision in *Armco Inc. v. Hardesty*, where the Court analyzed West Virginia's gross receipts tax scheme. That scheme had three key elements. First, West Virginia imposed a gross receipts tax of 0.27 percent on entities engaged in selling tangible property at wholesale. *Armco*, 467 U.S. at 642. Second, West Virginia exempted local manufacturers from that tax. *Id.* Third, West Virginia imposed a separate 0.88 percent tax on entities that manufactured tangible property in the state. *Id.*

West Virginia unsuccessfully defended its tax scheme on the same grounds that Petitioner advances on this appeal. West Virginia noted that the tax

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[8] The unargued assertion by the United States that there is "no logical reason" why the appropriateness of Maryland's tax on its own residents' income should depend on whether Maryland also taxes income earned by nonresidents is therefore critically mistaken and would, if adopted, effectively repudiate the entire concept of internal consistency. *See* U.S. Br. at 24.

burden on within-state transactions—*i.e.*, where the manufacturing and the wholesaling both occurred within the state—was 0.88 percent, while the tax burden on inbound transactions—*i.e.*, where the manufacturing occurred outside the state but the wholesaling occurred within the state—was only 0.27 percent. Just as Petitioner argues here, West Virginia maintained that there was therefore no discrimination against interstate commerce because the tax burden on commerce entering the state was lower than the rate on manufacturing inside the state. *Id.*

West Virginia's argument overlooked the fact that its 0.88 percent tax on manufacturing already imposed a burden on outbound transactions because many of the goods manufactured within the state were sold outside the state as well as inside it. This 0.88 percent outbound transaction tax combined with the 0.27 percent inbound transaction tax on property manufactured outside the state to create a combined tax burden of approximately 1.15 percent on cross-border transactions. Because this combined burden on interstate commerce exceeded the 0.88 percent tax burden on purely within-state commerce, the resulting tax scheme discriminated against interstate commerce and favored within-state commerce, just like a tariff.

The Court in *Armco* correctly pinpointed the discriminatory nature of the tax by applying the internal consistency test. *Id.* at 644. It noted that if every state copied West Virginia's tax scheme, property manufactured in one state and wholesaled in another would face a combined 1.15 percent tax burden, resulting from the 0.88 percent manufacturing tax plus the 0.27 percent wholesale tax. *Id.* Property

manufactured and wholesaled in the same state, however, would face only a 0.88 percent tax burden. *Id.* Because the math underlying this hypothetical nationwide tax compares the combined burden on cross-border activity against the tax burden on within-state commerce, it accurately captures the discriminatory structure of the West Virginia tax scheme.

The same reasoning applies to this case. If every jurisdiction copied Maryland's partial-credit tax scheme, all income earned by one state's resident in another state would be subject to a combined tax burden of 6.0 percent plus the county tax rate. Specifically, the state in which the income was earned would impose a 6.0 percent tax and the residence state would impose a tax equal to the county tax rate (*i.e.*, a before-credit tax of 4.75 percent plus the county tax rate, minus a credit of 4.75 percent for the tax paid to the state in which the income was earned). Meanwhile, all within-state income earned by a resident would be subject to a tax of 4.75 percent plus the county tax rate. The resulting combined tax burden on cross-border activity would exceed the tax on within-state transactions by approximately 1.25 percentage points.[9] Like the tax scheme in *Armco*, Maryland's tax scheme does not satisfy the internal consistency test, and the

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[9] As discussed above, the exact combined tax burden is slightly less than 1.25 percent because Maryland's tax should be considered to fall on the income that remains after paying the other state's income tax. *See supra* note 3. Such an adjustment is necessary for the internal consistency test to precisely track the concept of neutrality.

Maryland Court of Appeals' decision to strike it down may be affirmed on that basis. Pet. App. at 19-23.[10]

III. THE 1975 AMENDMENT ELIMINATING MARYLAND'S FULL TAX CREDIT ON OUTBOUND TRANSACTIONS FACIALLY DISCRIMINATES AGAINST INTERSTATE COMMERCE.

Finally, the Court may affirm on the ground that the specific legislative act that transformed Maryland's tax scheme from a full-credit to a partial-credit regime is itself facially discriminatory. Although the current tax regime would burden interstate commerce disproportionately regardless of the process that led to its enactment, the sequence of events highlights the essentially discriminatory nature of the scheme.

Prior to 1975, Section 290 of the Maryland tax code provided residents who earned income out of state a full credit for all taxes paid to another state. *See Blanton*, 390 Md. at 541. The statute read as follows:

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[10] One potential limitation of the internal consistency test is that it obscures the risk of discrimination that results even in a full-credit regime. Because the internal consistency test assumes that every state employs the same tax rate as the resident state, a full-credit regime would satisfy the internal consistency test even though such arrangements are in fact discriminatory when another state's income tax rate is less than the state of residence. It is particularly striking that Maryland's partial-credit regime fails the internal consistency test, even though that test validates a full-credit arrangement.

> § 290. Credit allowed residents.
>
> Whenever a resident individual of this State has become liable for income tax to another state … the amount of income tax payable by him under this subtitle shall be reduced by the amount of the income tax so paid by him to such other state . . . .

Md. Code Ann., art. 81, § 290 (1957, 1975 Repl. Vol.).

In 1975, the Maryland legislature amended Section 290 to exclude from the credit any amounts owed for the county tax, thereby increasing the tax burden paid by Maryland residents on income earned from outbound transactions. *Blanton*, 390 Md. at 541-42. The relevant part of that legislative enactment read as follows:

> (b) . . . [W]ith respect to the taxable year 1974 and each taxable year thereafter, the credit provided for by this section operates to reduce only the State income tax payable under this subtitle and does not operate to reduce any local income tax imposed . . . .

Act of Feb. 11, 1975, ch. 3, 716 Md. Laws 7, 8, *available at* http://msa.maryland.gov/megafile/msa/speccol/sc2900/sc2908/000001/000716/html/am716--8.html (codified as amended at Md. Code Ann., art. 81, § 290(b)).[11]

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[11] The Maryland tax statute was recodified in 1988, and the relevant provisions are now set forth in Md. Code Ann., Tax-Gen. § 10-703, which provides in relevant part:

> (a) *In general.* — Except as provided in subsection (b) of this section, an individual may claim a credit only against

On its face, this amendment targets interstate commerce. It raises revenue for the state by placing an additional burden only on cross-border activity. The fact that the discrimination takes the form of a credit is immaterial under this Court's precedent. In *Maryland v. Louisiana*, 451 U.S. 725 (1981), for example, the Court considered a Louisiana tax scheme that imposed a tax on certain natural gas brought into the state but provided residents with a credit for certain other taxes paid. The Court struck down the scheme, observing that the credit for within-state taxes encouraged the recipients of the credit to engage in within-state commercial activity instead of engaging in interstate commerce. *Id.* at 756 (observing that the tax "unquestionably discriminates against interstate commerce in favor of local interests as the necessary result of various tax credits and exclusions"); *see also Scheiner*, 483 U.S. at 306 (Scalia, J., dissenting) ("A credit against intrastate taxes falls readily within the highly suspect category"); *Westinghouse Elec. Corp v. Tully*, 466 U.S. 388, 404 (1984) (noting that disallowing a tax credit would have the identical discriminatory economic effect as imposing a higher tax).

Just as a discriminatory export tariff is the mirror image of an import tariff, Maryland's decision to reduce the credit it provides its residents is the mirror image of Louisiana's discriminatory grant of a credit to residents for within-state taxes. Like Louisiana's

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> the State income tax for a taxable year in the amount determined under subsection (c) of this section for tax on income paid to another state for the year.

Md. Code Ann., Tax-Gen. § 10-703(a) (1988).

extension of a credit, Maryland's reduction of a credit has reduced the incentives for its residents to engage in commercial activity in other states. Both taxes are facially discriminatory. *See Maryland*, 451 U.S. at 756-57 (concluding that the Louisiana tax scheme is discriminatory "[o]n its face").

It is no defense for Petitioner to argue here that the intent of the 1975 amendment was merely to ensure that all Maryland residents "paid at least some taxes to support government programs." Pet. Br. at 41. Maryland pursued that goal in a constitutionally impermissible manner by singling out and deliberately increasing the tax burden on cross-border commercial activity. The circumstances giving rise to the amendment, therefore, are no different from those in which a state imposes a neutral retail sales tax on the in-state sales by resident and nonresident sellers only to find that some resident sellers pay no such tax because they sell exclusively outside the state. It would be facially discriminatory for the state to "fix" that problem by imposing an export tariff on out-of-state sales. Maryland's decision to reduce the credit for taxes paid on residents' out-of-state income is equally discriminatory on its face.

Because the 1975 amendment is a facially discriminatory piece of legislation, it is "virtually *per se*" invalid, unless the state can show that it has "no other means to advance a legitimate local purpose." *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330, 338-39 (2007). Petitioner cannot satisfy that burden because there is no constitutional impediment to its local goal of taxing all Maryland residents to pay for the benefits they

receive. There is nothing discriminatory about a tax on the income of state residents wherever earned. Maryland, however, *cannot* tax the income of its residents wherever earned while also imposing a comparable tax burden on nonresidents, because the combination of those two taxes amounts to an unconstitutional burden on interstate commerce. The Maryland Court of Appeals therefore correctly determined that the 1975 amendment contravenes the Constitution. Pet. App. at 32, 34.

IV. PETITIONER'S CONCERNS REGARDING STATE SOVEREIGNTY ARE MISPLACED.

The Court should reject the various arguments raised by Petitioner and its supporting *amici* in favor of reversal. All of those arguments proceed from the misconception that Maryland's tax on the income of its residents can be considered in isolation from its tax on the income of nonresidents.

First and foremost, Petitioner errs in claiming that this case turns on Maryland's right to tax the income of its residents, wherever earned. *See* Pet. Br. at 2. It does not. There is nothing discriminatory about a neutral residence tax on the income of Maryland residents wherever earned. However, merely because Maryland has the right to tax residents does not mean that it has the right to do so in a manner that discriminates against interstate commerce. *W. Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 203 (1994) ("State taxes are ordinarily paid by in-state businesses and consumers, yet if they discriminate against out-of-state products, they are unconstitutional."). Petitioner improperly relies on *dicta* in *Goldberg v. Sweet*, 488 U.S. 252, 266 (1989), which states that it is not the

purpose of the Commerce Clause to protect residents from the taxes of their own state. *See* Pet. Br. at 2, 42. Neither *Goldberg* nor any other case of this Court has held that a state has the right to tax its residents in a manner that discriminates against cross-border activity. To the contrary, the Court has expressly rejected that view. *W. Lynn Creamery*, 512 U.S. at 203.

Second, Petitioner is mistaken to suggest that affirming the judgment of the Maryland Court of Appeals requires this Court to hold that states, as a constitutional matter, must offer residents full credits for taxes paid to other jurisdictions. *See* Pet. Br. at 17, 26-27. To avoid discriminating against interstate commerce, states need not offer residents full tax credits. States may tax residents' out-of-state income as much as they like as long as they avoid simultaneously taxing nonresidents' in-state income at a rate that, combined with the tax on residents' out-of-state income, exceeds the tax on residents' in-state income. However, when a state imposes an income tax at comparable rates on residents' income earned out of state, residents' income earned within the state *and* nonresidents' income earned within the state, then at a minimum it must offer a full credit for taxes paid by residents to other jurisdictions to mitigate the discriminatory double burden that its tax system imposes on interstate commerce. A partial credit under those particular circumstances is insufficient.

Third, Petitioner's argument that the political process will safeguard against discrimination is misplaced. *See* Pet. Br. at 24-26, 41-43. The discriminatory nature of Maryland's tax scheme stems from the decision to tax the income of nonresidents.

Nonresidents have no electoral say in Maryland's tax on their income. There is no political mechanism to rectify the resulting discrimination against interstate commerce. Invalidating Maryland's discriminatory tax scheme under the dormant Commerce Clause is therefore a particularly appropriate means to protect interstate commerce from unconstitutional discrimination. *S. Pac. Co. v. Arizona ex rel. Sullivan*, 325 U.S. 761, 767 n.2 (1945) ("[T]he Court has often recognized that to the extent that the burden of state regulation falls on interests outside the state, it is unlikely to be alleviated by the operation of those political restraints normally exerted when interests within the state are affected.").

CONCLUSION

For the foregoing reasons, the tax economists *amici* respectfully submit that the Court should affirm the judgment of the Maryland Court of Appeals.

Respectfully Submitted,

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