

Taxpayers Wynnes: A recent US Supreme Court decision may provide refund opportunity for New York City residents

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State and local income tax issues do not often reach the US Supreme Court. Recently they did. In question was whether Maryland resident taxpayers should get a tax credit for taxes paid to other states against their Maryland county income tax liability. While the state of Maryland State Comptroller argued that the credit was not available, the Maryland Court of Appeals and the US Supreme Court disagreed and granted the credit to the taxpayers.

While this case might be specific to Maryland, it is important for other states too. States across the country are no doubt looking closely at this case and evaluating whether their statutes need revision. This could be a compelling opportunity for multi-state taxpayers – including but not limited to those in New York City.

A Quick Synopsis of the Case...

In a 5-4 split decision by the US Supreme Court in *Comptroller of the Treasury of Maryland v. Wynne* issued on May 18, 2015, the Supreme Court held that Maryland's personal income tax scheme was unconstitutional because it failed to provide Maryland residents with an income tax credit against their Maryland county tax for income taxes paid to other states. By failing to do so, the Court held that Maryland's personal income tax regime presumably violates the dormant Commerce Clause of the US constitution because it results in double taxation on the same income earned outside of Maryland and therefore causes Maryland residents who earn income in multiple states to pay Maryland income tax at a higher rate than Maryland residents who derive all of their income solely from Maryland activities.

For a little more detail on the Facts of the Case...

Maryland imposes both a state and county personal income tax on its residents. To prevent double taxation of its residents, it provides a credit against the state income tax for income taxes paid to other states with respect to income earned outside of Maryland but does not provide a similar credit against the county income tax.

Maryland residents, Brian and Karen Wynne, owned stock in a Subchapter S corporation, Maxim Health Services, Inc. In 2006, the Wynnes filed income tax returns in 39 states other than Maryland with respect to the income that flowed through to them from their investment in Maxim. The Wynnes also reported this income on their Maryland income tax return as required for Maryland residents and claimed a credit against both their Maryland state and county income taxes for income taxes paid to the other states. The Maryland State Comptroller of the Treasury denied their claim to the credit against their county tax and assessed a tax deficiency. The Wynnes challenged the denial of the credit and the resulting deficiency on US constitutional grounds.

US Supreme Court Decision

The Supreme Court affirmed the decision of the Court of Appeals of Maryland (Maryland's highest court) which had held that Maryland's personal income tax regime violated the dormant Commerce Clause of the US constitution by not permitting Maryland residents to claim a credit against the county portion of the state's income tax. The dormant Commerce Clause precludes states from "discriminat[ing] between transactions on the basis of some interstate element." In other words, a state may not tax a transaction more heavily when it crosses state lines than when it occurs entirely within the state.

In affirming the Court of Appeals of Maryland decision, the Supreme Court determined that the Maryland tax scheme was unconstitutional because it created the possibility of multiple taxation on the same income for Maryland residents. The Court explained its conclusion by noting that if all states enacted Maryland's tax scheme, interstate commerce would be subjected to a higher tax burden than intrastate commerce. As a result, Maryland's tax scheme provides an incentive for Maryland residents to choose to conduct their business intrastate rather than interstate and therefore operated as a tariff in violation of the dormant Commerce Clause. The Court illustrated its point with the following simple example:

Assume that every state adopted a personal income tax scheme similar to that adopted by Maryland: (1) 1.25% tax on income that a resident earns in the state, and (2) 1.25% tax on income that a resident earns in other jurisdictions. Assume further that two taxpayers, April and Bob, both

live in State A and that April earns her income in State A and Bob earns his income in State B. In this case, Bob will pay more income tax than April solely because he earns his income interstate. Specifically, April will have to pay a 1.25% tax once – to State A. In comparison, Bob will have to pay a 1.25% tax twice – once to State A (where he lives) and once to State B (where he earns the income). This result provides Bob with an incentive to conduct his business only in State A.

In concluding its decision, the Court left open the possibility that Maryland could cure its problem by, for example, allowing a full credit as to the county portion of its income tax for taxes paid to the other states.

Putting this into perspective – Potential Tax Planning Opportunities

Although the *Wynne* decision addresses only the validity of the Maryland county personal income tax, the decision calls into question the validity of other local taxes such as the New York City personal income tax. For example, an individual who is domiciled in New York City and who earns business income from sources outside New York State is entitled to a credit against his or her New York State income tax but not his or her New York City income tax.

By equating the Maryland county income tax to the Maryland state income tax for purposes of its analysis and indicating that a credit must be provided against both for the personal income tax scheme to be constitutional, the Supreme Court has essentially determined that the same dormant Commerce Clause analysis must also be applied to local income tax schemes. Therefore, similar to the example provided by the Supreme Court, a person who is domiciled in New York City (combined NYS/NYC highest marginal tax rate of 12.696%) and owns income generating real estate in California (highest marginal tax rate of 13.3%), would receive a credit against his or her New York State income tax (highest marginal tax rate of 8.82%) for taxes paid in California but would not receive a credit against his or her New York City income tax with respect to this income. As a result, the individual would pay double tax on the income – California and New York City – and therefore would have an incentive to limit its business activities to New York State. As a result of *Wynne*, New York City taxpayers may have a refund opportunity for all open years.

Furthermore, *Wynne* may also provide a refund opportunity for New York statutory residents who are domiciled elsewhere. Under New York State (and New York City) law, an individual is a statutory resident if the individual maintains a permanent place of abode (e.g., apartment) in New York and spends more than 183 days in New York during the year. Because New York imposes its income tax on all of a statutory resident's income (not just the income earned in New York), a statutory resident can be subject to income tax in both New York and the individual's state of domicile on his or her entire income. This result is not entirely eliminated by the New York tax credit granted for income taxes paid to other jurisdictions because this credit is not afforded with respect to taxes paid to another jurisdiction on investment income from intangible property such as interest, stock dividends and capital gains. Consequently, the individual pays income tax on this income twice – once in New York and once in the state of domicile.

Practical Application – What to do next

Some years ago (in 1998) the New York Court of Appeals (New York's highest court) ruled in *In the Matter of John Tamagni vs. Tax Appeals Tribunal of the State of New York* that this taxing scheme was constitutional. However, the US Supreme Court has now brought this back into focus and the validity of the older NY decision may now be subject to doubt under the holding of *Wynne*.

As a result of *Wynne*, individuals who have paid income tax to New York as a statutory resident may wish to consider filing protective refund claims for all open years.

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