Constitutional Limitations

Ernst & Young’s Rebecca Helmes goes behind the scenes with Christopher Handman, Richard O’Connor and Dominic Perella, the counsels for the Wynnes in the landmark U.S. Supreme Court Case. The counsels discuss the surprising decision by the U.S. Supreme Court to grant cert., various questions posed by the justices during oral argument and the implications the holding in Wynne will have in other states.

Behind the Scenes on ‘Wynne’: An Interview With the Wynnes’ Counsels

BY REBECCA HELMES

The strength of the internal consistency test as a “living and breathing test” applicable to Constitutional interstate commerce questions is a key takeaway from a recently issued U.S. Supreme Court case on state and local taxes, Comptroller of the Treasury of Maryland v. Wynne, No. 13-485 (U.S. May 18, 2015), according to one of Wynnes’ counsels in a recent webcast by Ernst & Young LLP.

During the webcast, Ernst & Young LLP interviewed counsels for the Wynnes and got their take on everything from how the case developed starting in the Maryland Tax Court to their insight on the U.S. Supreme Court opinion issued two weeks ago.

In Wynne, the U.S. Supreme Court held in a 5-4 decision that Maryland’s personal income tax scheme violates the federal Constitution via the dormant commerce clause because it discriminates against interstate commerce and functions as a tariff.

Under Maryland’s personal income tax structure, the state imposes a state income tax and a county income tax. The state grants credits for taxes paid to other jurisdictions against the state income tax, but does not allow for credits against the county income tax.

“That is the crux of the issue that was before the court,” said Jeff Saviano, Director of Indirect/U.S. State and Local Tax at Ernst & Young LLP, during the webcast. “Justice Alito wrote the majority decision and held that they can’t impose a tax that discriminates against interstate commerce, and this case is loaded with issues...
and implications for many of the nearly 1800 companies who are on this webcast today.”

“I think this is probably the most significant case in the last 30 years involving state and local tax, certainly since Quill [Quill Corp. v. North Dakota, 504 U.S. 298 (1992)],’’ said Steven N.J. Wlodychak, Principal with Ernst & Young LLP in the firm’s Center for State Tax Policy.

Five justices favored the taxpayer (Justices Alito, Kennedy, Breyer, Sotomayor and Chief Justice Roberts), holding that Maryland’s tax scheme discriminates against interstate commerce and operates as a tariff. Justice Ginsburg wrote the primary dissent, joined by Justices Kagan and Scalia, stating that the dormant commerce clause was not intended to protect citizens from their own state, and that a certain state tax credit is really something more of a policy matter rather than a Constitutional requirement. Justice Thomas wrote a separate dissent in which he said there is no such thing as the dormant commerce clause, and then joined Justice Scalia on part of Scalia’s dissent, in which Scalia wrote about the “imaginary” dormant commerce clause providing imaginary benefits.

“Justice Scalia has been long known to be an opponent of the dormant commerce clause, that it is not a part of the Constitution,” Wlodychak said.

Case Background

The Maryland Comptroller audited the Wynnes’ 2006 Maryland tax return, said Richard O’Connor, corporate tax director at Maxim Healthcare Services Inc. and counsel for the Wynnes. Brian Wynne was a shareholder in a Subchapter S company.

“We decided to use that audit as a vehicle to argue that the failure to give a credit against the county tax, or the Other State Tax Credit (OSTC), violated the dormant commerce clause,” O’Connor said. “Our thinking was that we focused almost single-handedly on the Complete Auto case [Complete Auto Transit v. Brady, 430 U.S. 274 (1977)] and the four different requirements in that case for a state tax statute to survive a Constitutional challenge, and we felt that Maryland’s statute did not survive two of those tests.”

O’Connor said that he had a brief conversation with Brian Wynne and convinced him to make the Constitutional argument.

“His only question was, ‘Is this a serious argument? Do we have a serious chance of winning?’ And we assured him that he did,” O’Connor said. “We then immediately lost in the Maryland Tax Court in a summary decision. It was either one or two sentences.”

They hired Christopher Handman, then a partner at Hogan Lovells, and brought the case before the Maryland Circuit Court—in this case, the Howard County Circuit Court—according to Maryland rules.

Handman, who is now general counsel at Snapchat Inc. in California, said that in the circuit court, jurists are typically not dealing with Constitutional law, particularly not the dormant commerce clause.

“There’s always a concern that you’re not going to get a fair hearing. After all, you’re telling, in this case, a county judge to strike down a county tax that sometimes is being used to pay his or her salary,” Handman said, or other parts of county infrastructure. Handman said he told O’Connor to be prepared to get an adverse decision and that it would be something that they would likely have to take up at the appellate stage.

But they won.

“The circuit court judge wrote an 80-plus page opinion . . . and it was a complete across-the-board embrace of the various positions that we had set out as to why this tax on at least three different levels violates the principles of nondiscrimination that the dormant commerce clause is designed to protect,’’ Handman said.

When the state appealed, Handman said the Wynnes took the strategic view that they wanted to get the case finished as fast as possible. They used an “arcane” aspect of process in Maryland and filed a certiorari bypass requesting that the Maryland Court of Appeals (the highest court in the state) take the case directly, rather than going before Maryland’s intermediate appeals court.

They won in the Maryland Court of Appeals with a 5-2 decision.

“The Maryland Court of Appeals does not have a reputation as being a very taxpayer-friendly court, and yet you have a solid win there,” Wlodychak said. “Did you have any idea that the comptroller’s office would appeal this all the way to the U.S. Supreme Court because that would be the next level? What was the thought process there?”

Handman said he thought the U.S. Supreme Court would have no interest in the case. Normally, the U.S. Supreme Court will take a case where it is the court of last resort for appeals, or where there is a question with major federal implications.

Here, there was no split among the lower courts and the federal government was not arguing that there was an adverse effect. The only adverse effect here was on Maryland commerce, said Dominic Perella, former Hogan Lovells attorney who argued the case on the Wynnes’ behalf in the U.S. Supreme Court. He has since become deputy general counsel at Snapchat Inc.

“We didn’t think there was a particularly high likelihood of it going anywhere, but obviously we were mistaken on that front,’’ Dominic Perella said about the cert. petition.

“With so many cases that we thought were of Constitutional import, like Lanco, MBNA, Amazon.com, Overstock, all those major cases dealing with dormant commerce clause issues going to the Supreme Court and just summarily being denied certiorari, nobody would have thought that the Wynnes’ case would have gotten their attention, particularly with that solid decision below in the Maryland courts,’’ Wlodychak said.

However, Perella said this was not a straight-ahead cert. grant—instead, the U.S. Supreme Court asked the U.S. Solicitor General’s office to weigh in with their view on whether cert. should be granted.

“I certainly expected that the recommendation would be for a denial of cert.,” Perella said. “I didn’t think the Solicitor General would find a national interest.” The Solicitor General took the position that cert. should be granted and that the Supreme Court should side with Maryland on the merits.

Perella said when the Solicitor General recommends a grant of cert., the Supreme Court most times grants it.

“We knew we were facing a battle on the merits at that point,” Perella said.
U.S. Supreme Court Arguments

The Wynnes’ key arguments focused on double taxation, the internal consistency test and that apportionment for corporations should be the same for individuals.

Perella said he immediately tried to figure out where the justices stood on the arguments. He said they knew from previous writings that they had at least a decent shot of picking up Chief Justice Roberts and Justices Kennedy, Breyer and Alito—four out of the necessary five. “We were hoping to hear supporting questions from them, and then certainly to hear supportive questions from at least one other justice, and we did.”

“I had a feeling that by the time I stood up that those four were at least on the fence if not in our camp, and so then the question was where was the fifth vote,” Perella said. He said the theme of tariffs was a big one, and when questioned at oral arguments, Maryland’s counsel seemed to concede that the tax was in fact a tariff. So when he got up, he went straight for the tariff discussion—which he thought had the merit of appealing to a doctrinal conservative. But he also underscored the fact that this was a tax that was harming small businesspeople who tried to expand their businesses across state lines—which was a theme he thought would appeal to the left side of the court.

“By the time the hearing was over, I must say that I was confident that we were in the running, I was confident we had four votes, I was hopeful that we had five but I wasn’t sure who was the fifth,” Perella said. “And I was somewhat surprised and obviously thrilled. . .that Justice Sotomayor had taken our side.”

O’Connor said that he loved the comment made by Justice Sotomayor when she complained a little bit about New York City’s failure to give her a credit.

“Obviously Justice Sotomayor has deep background and roots in New York, I wouldn’t be surprised if that wasn’t at least a little bit relevant to her thinking,” Perella said. “I also like to hope that relevant to her thinking was the idea that it doesn’t make a whole lot of sense to give C-corporations preferential treatment vis-à-vis other types of corporate entities and individuals when it comes to tax. That was a theme that we consciously decided to play up as a separate section in our merits briefing,” Perella said. He said they chose to play it up not just because it was forceful, but also because they thought it would resonate with the left side of the court.

Wlodychak said that the tariff argument that figured so prominently in Alito’s majority opinion was brought up in an amicus brief by Tax Economists—not the parties—and said that not just one but three of the justices brought up the tariff concept during oral arguments.

Perella said he prepared to talk about the tariff argument, and he was concerned that not all of the points made by the Tax Economists lined up precisely—but it ended up working out in the end.

“The bottom line was it was incredibly helpful for us,” Perella said.

Perella said he was really interested to learn where the doctrine ended up based on the case.

“I really find it interesting that they ended up equating internal inconsistency with tariff, and also with discrimination. Justice Alito’s opinion doesn’t try to separate out those three concepts. He accepts the idea that an internally inconsistent tax is a tariff, and he says an internally inconsistent tax is discriminatory, and essentially collapses all of those inquiries into the internal consistency test,” Perella said. “And I think there was quite a bit of questioning in the Constitutional bar and the tax bar prior to this case about whether internal consistency was still a living and breathing test, and I think the answer obviously is yes, and in fact I think this opinion signals that a lot of the dormant commerce clause analysis in the area goes straight to internal consistency going forward. The viability of the other prongs I think remains to be seen.”

In her primary dissent, Justice Ginsburg’s argument focused on fairness—and the conflict between the state’s power to tax all of the income of its residents, versus the commerce clause’s disallowance of discrimination against interstate commerce.

Perella said that Ginsburg’s focus on fairness was a parochial approach in the big picture of state taxation. There are people who have income from other states and who therefore pay less tax in their state of residence via tax credits, but Perella said the effects of that even out across 50 states. In addition, there are other taxes, such as property taxes, sales and use taxes, etc., which are not affected by these provisions. Finally, Perella said an analysis that somehow individuals take state services in a way that corporations do not just does not hold up.

On Justice Thomas’ dissent, Perella said that Justice Thomas does not believe in the dormant commerce clause, and their argument was based on the dormant commerce clause—so his role in the case was a foregone conclusion.

Overall, coming out of Wynne, Handman said that there is a majority of support for tax on residency and source, provided the scheme is internally consistent. A difference in rates between the states would not cause the tax to fail the internal consistency test.

Implications for Other States

Perella said he knows there are local jurisdictions that impose income tax without providing credits, but he thinks the amici in the U.S. Supreme Court case overstated the problem. There will, however, be litigation over those liabilities.

Further, when asked about the implications of this case for other kinds of state taxes, Perella said he does not think that Wynne’s outcome means that other taxes will be treated the same way as income tax.

“I think there is room in the jurisprudence to distinguish other types of taxes and treatments differently than the treatment you saw in the Wynne decision,” Perella said.