Discrimination Against Interstate Commerce vs. Double Taxation

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- Michael Knoll and Ruth Mason, What Is Tax Discrimination*?,* 121 **Yale L.J.** 1014 (2012).
- Ryan Lirette and Alan D. Viard, State Taxation of Interstate Commerce and Income Flows: The Economics of Neutrality (American Enterprise Institute Economic Policy Working Paper 2014-07, 2014).

For good reasons on balance, the best academic work in tax (and other) law has moved far away in recent decades from focusing primarily on which answers to particular questions are legally correct. Not only have scholars wanted to pursue larger game than just the current, inevitably flawed, state of the law, but it is often hard to say what "legal correctness" means. Writing about policy, rather than just about legal correctness, not only broadens the menu of possible topics, but permits one to devise clearer criteria for assessing the merits of competing arguments.

There is, however, a downside to thus broadening, diversifying, and deepening the menu of favored topics. Having a positive influence on real world legal outcomes, especially if one can get there without having to tailor one's analysis or conclusions in the manner of either a politician or a hired litigator, is both good in itself and something that we ought to care about—both as lawyers and as academics—as a matter of professional responsibility.

It is therefore a great thing to see tax academics and other members of the broader tax policy community actually swaying the outcome of a Supreme Court case in a good way. This happened in Comptroller v. Wynne, decided on May 18, 2015, in which an unusual Supreme Court majority composed of three conservatives (Alito, Kennedy, and Roberts) and two liberals (Breyer and Sotomayor) converged to strike down a Maryland income tax rule as discriminatory against interstate commerce. The majority opinion not only extensively cited work by tax scholars, but really relied on it, not just to decide the case at hand, but also to clarify the often-vexed law of how one should define discrimination under the dormant commerce clause. The Court drew on two amicus briefs (one by Michael Knoll and Ruth Mason and the other lead-authored by Alan Viard) which arose out of and/or applied academic work by both sets of authors,[1] and gave both coherent economic content and usable formulations to the potentially nebulous idea of tax discrimination.

Why might it be desirable for the courts to strike down clear instances of interstate tax discrimination? It's well-known that, as soon as two jurisdictions' income tax systems differ even just in rates, perfect tax neutrality is unattainable as between economic activity in any one jurisdiction and both that which is inbound and that which is outbound from its perspective. So the courts cannot mandate full neutrality, short of requiring complete uniformity between tax systems. Nor can they police all interactions between jurisdictions' tax rules that might happen to disfavor interstate commerce in particular instances, simply due to incomplete harmonization between the jurisdictions' rules.

However, there is reason to think that jurisdictions will sometimes be inclined to impose undue burdens on cross-border activity, whether because outsiders can't vote or due to the set of internal collective action problems that may yield protectionist legislation even when this harms local consumers. Thus, assuming a good enough test for discrimination against interstate commerce, the courts can potentially

improve public policy by applying it. Unfortunately, reflecting the difficulty of the underlying conceptual issues, courts have often done quite poorly at devising workable tests.

In this regard, as Mason and Knoll have written, one good tool that actually can be found in existing Supreme Court jurisprudence is the "internal consistency" test. Here one asks, about a tax rule such as that which Maryland applied in the *Wynne* case: If *all* jurisdictions applied the same rule as this one, would cross-border activity be disfavored? In illustration, suppose New York taxes all outbound investment but no inbound investment, while New Jersey taxes all inbound investment but no outbound investment. While this would be unfortunate for New York-to-New Jersey investment, it wouldn't violate internal consistency. Use of the test may be motivated by the points that (a) there might be good reason for a state's focusing either just on inbound or just on outbound investment, and (b) neither New York nor New Jersey is inherently to blame if the other state happened to make an opposite choice.

As generalized by Viard, one can put the point roughly as follows. Just by looking at one jurisdiction's set of rules, one can discern discrimination against interstate commerce if the sum of (a) the tax rate on outsiders' in-state income and (b) the tax rate on residents' out-of-state income exceeds (c) the tax rate on insiders' in-state income.[2] Thus, for example, if Maryland were to tax purely in-state income at 5 percent, and all inbound and outbound income at 3 percent, it would be discriminating against interstate commerce, as two identical Marylands would levy a 6 percent combined rate on cross-border activity.

In actual practice, what Maryland did was combine fully taxing inbound income by nonresidents, with partly taxing outbound income by residents. For the latter, Maryland allowed a credit for taxes levied by other states, but only for a portion of the Maryland income tax liability. While the Maryland Court of Appeals had struck down this approach as discriminatory against interstate commerce, its ground for doing so was incoherent, reflecting an aversion to "double taxation" that the Supreme Court was unlikely to affirm. Conceptually, what matters is the overall tax burden on economic activity, not how many times one is taxed. And given the conundrum illustrated by the New York / New Jersey example above (which state should be treated as the one that's "wrong"?), it is hard to base a workable tax discrimination test on the supposed principle of preventing double taxation.

The Supreme Court's test is better. It required Maryland to devise a nondiscriminatory approach of some kind, based on the internal consistency / total tax burden analysis advanced by Knoll and Mason and by Viard and co-authors, and not necessarily including the use of tax credits. Considered in isolation, the result in *Maryland Comptroller v. Wynne* is surely of only modest importance. But the authors of the above amicus briefs, by effectively deploying their professional expertise regarding coherent legal and economic analysis in the service of improving the law, have not only put dormant commerce clause analysis generally on a better path, but offered an inspiring example to the rest of us.

1. See Ruth Mason, Made in America for European Tax: The Internal Consistency Test, 49 **B.C. L. Rev.** 1277 (2008); Alan D. Viard, The Real Issue in Wynne is Discrimination, Not Double Taxation , State Tax Notes, January 15, 2015.
2. Viard, supra, at 46. As Viard explains, the computation must be slightly adjusted to reflect tax rate interactions.

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