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Revisiting Local Income Taxes

In *Wynne*, the Supreme Court for the first time held that the Constitution *requires* a taxpayer's state of residence to provide a credit to the resident for income taxes paid to other states, if the tax is levied based on residence and not source.[1] Although Maryland was unique in its failure to grant any credit to state income taxes paid,[2] *Wynne* may require significant changes to the ways state and local government income taxes credit taxes paid to other jurisdictions. Even scholars supportive of the court's primary holding have noted the uncertainty *Wynne* creates.[3]

For local governments, *Wynne*'s holding raises three related questions. First, what is a local tax versus a state tax? (*Wynne* itself dodges this question because the nominally "county" income tax at issue in the case was considered part of the "state income tax" under state law.) Second, must local income taxes offer credit against both state *and* local government income taxes levied by other jurisdictions? (*Wynne* likely suggests yes.) And third, what counts as an "income" tax for purposes of such a credit? (*Wynne* offers very little guidance.) In its Amicus Brief in support of Maryland, the Multi-State Tax Commission notes the complexity of this final challenge. The commission feared that the credit requirement "would trigger an onslaught of challenges to myriad state and local taxes which could be considered duplicative or overlapping in

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[1] Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787, 1792 (2015).
[2] *Id.* ("But unlike most other States, Maryland does not offer its residents a full credit against the income taxes that they pay to other States.").
[3] See, e.g., Walter Hellerstein, *Deciphering the Supreme Court's Opinion in* Wynne, J. TAX'N, July 2015, at 4; *Knoll Argues Philadelphia Wage Tax Unconstitutional in New Essay*, UNIV. PA. LAW SCH. (Apr. 21, 2016), https://www.law.upenn.edu/live/news/6106-knoll-argues-philadelphia-wage-tax#.WA5GxrxpG2w.

some fashion and would involve the courts in second-guessing state and local policy decisions."[4]

Against this changing legal landscape, scholars need to revisit local income tax laws. It has been years (decades?) since legal scholarship has seriously explored the role of local income tax laws in municipal finance.[5] Local income taxes provide significant revenue to some of the United States' major cities and are a major part of municipal and county revenue in several states. Efforts to reform these local income taxes are perennial. Changes required by *Wynne* may, in fact, provide the opportunity to bring other needed reforms.

The first part of the paper will look at *Wynne* and the changes it wrought to the Dormant Commerce Clause jurisprudence. The second part of the paper will explore the role of local income taxes in local government revenue and the challenges faced by those seeking to reform local income tax laws. The third part of the paper will look at the implications of *Wynne* for local income tax systems across the country, and the fourth, and final section, will explore the ways *Wynne*-related reforms might provide an opportunity to rethink other aspects of local income tax law, including administration, conformity with state tax bases, and definitions of residency.

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[4] Brief of Multistate Tax Comm'n as Amicus Curiae in Support of Petitioner Md. State Comptroller of the Treasury at 21, Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787 (2015) (No. 13-485) 2014 WL 3943824, at *21.

[5] For a survey of the earlier literature, see, e.g., Paul J. Hartman, *Municipal Income Taxation*, 31 ROCKY MTN. L. REV. 123, 123–24 (1958); Joe G. Davis, Jr. & Arthur J. Ranson, III, Note, *An Evaluation of Municipal Income Taxation*, 22 VAND. L. REV. 1313, 1313 (1969); Leonard Kirschner, *The Municipal Income Tax*, 20 U. CIN. L. REV. 343, 348 (1951) ("The most convincing argument in favor of the tax is that it will reach the non-resident using city facilities, who currently contributes nothing to the city government."). *See generally* ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, SR-10, LOCAL REVENUE DIVERSIFICATION: LOCAL INCOME TAXES (1988), http://www.library.unt.edu/gpo/acir/Reports/staff/SR-10.pdf (discussing municipal revenue sources); Gary Sperling, *Municipal Income Taxation and Home Rule*, 1 URB. LAW. 281 (1969) (discussing municipal income tax feasibility under current home rule provisions). *But see* Knoll & Mason,.

Part I: The Case

In the first Part of this Article, I provide some background on the Dormant Commerce Clause, the challenge brought under the Commerce Clause, and the Supreme Court's opinion in *Wynne*.

A. The Dormant Commerce Clause

The Commerce Clause gives the U.S. Congress the power "to regulate commerce with foreign nations, and among the several states, and with the Indian tribes."[6] As law students learn in their Constitutional Law course the dormant commerce clause arises as a negative inference of this explicit grant of Congressional power. Even when Congress has not acted, parties can evoke this negative implication of the Commerce Clause and ask courts to restrict state regulation of interstate commerce. The doctrine dates to the early years of the Republic. As Justice Johnston observed,

> It has been contended by the counsel for the appellant, that, as the word 'to regulate' implies in its nature, full power over the thing to be regulated, it excludes, necessarily, the action of all others that would perform the same operation on the same thing. There is great force in this argument.[7]

The term "dormant commerce clause" was coined by Chief Justice Marshall in *Wilson v. Black Bird Creek Marsh Co*.[8] The idea of this dormant commerce clause was evoked in dicta concerning state regulation of interstate commerce.[9] The first state law struck down under the Dormant Commerce Clause, however, was a state tax statute.[10] For a long time, the Court's jurisprudence focused on formal distinctions between taxes that directly

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[6] U.S. CONST. art. 1, § 8, cl. 3.
[7] Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 209 (1824).
[8] Wilson v. Black Bird Creek Marsh Co., 27 U.S. 245, 252 (1829).
[9] *See* Cooley v. Board of Wardens, 53 U.S. (12 How.) 299, 319 (1852); *Gibbons*, 22 U.S. at 209.
[10] *In re* State Freight Tax, 82 U.S. 232 (1872).

taxed interstate commerce and those that only indirectly burdened such interstate transactions.[11]

The Court eventually repudiated this formalist approach, first in the regulatory context,[12] and then later in the context of Dormant Commerce challenges to state taxing authority.[13] In the tax context, the Court adopted a four-part test of the constitutionality of a state taxing statute.[14] Under the *Complete Auto* test, a court will "sustain[] a tax against Commerce Clause challenge when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[15]

Exactly how courts should interpret the four-pronged *Complete Auto* test is a question that has been litigated almost continuously since 1977. As Justice Scalia, a long-time critic of the Court's Dormant Commerce Clause jurisprudence, argued, "[t]he fact is that in the 114 years since the doctrine of the negative Commerce Clause was formally adopted as holding of this Court, . . . our applications of the doctrine have, not to put too fine a point on the matter, made no sense."[16]

The majority of these Dormant Commerce Clause challenges involve corporate taxes, and the Supreme Court has heard remarkably few dormant commerce clause challenges to state personal income tax laws. That is one reason *Wynne* is so remarkable.

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[11] *See* Freeman v. Hewett, 329 U.S. 249, 252–53 (1946) (criticizing formalist approach); Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 281 (1977); *see also* Jesse Choper & Tung Yin, *State Taxation and the Dormant Commerce Clause: The Object-Measure Approach*, 1998 SUP. CT. REV. 193 (1998); Hellerstein, *supra* note 3.
[12] *See generally* Pike v. Bruce Church, Inc., 397 U.S. 137 (1970).
[13] *See generally Complete Auto Transit, Inc.*, 430 U.S. 274.
[14] In *Quill*, the Court characterized the *Complete Auto* test as a test under the Dormant Commerce Clause, though *Complete Auto* itself seems to understand the test as broader. *See Quill.*
[15] *Complete Auto Transit, Inc.*, 430 U.S. at 279.
[16] Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue, 483 U.S. 232, 259–60 (1987) (internal citations omitted).

B. Factual Background

Brian and Karen Wynne live in Sykesville, Maryland, in Howard County. Brian Wynne founded Maxim Healthcare Services, a medical staffing company organized. Maxim earned income in 39 states in 2006. Under federal tax law, closely held corporations can opt to receive pass-through treatment of their income. Such corporations are known as s-corp. Maxim is an s-corporation, and as a result, it paid no federal corporate tax. Instead, Maxim's shareholders, including Brian Wynne, included the corporation's income (in proportion to their ownership interests) on their individual tax returns. Maryland respects the federal s-corporation election. Thus, the Wynnes reported Brian's share of Maxim's corporate income on their Maryland and federal tax returns for 2006.

Under Maryland tax law, the Wynne's state-level income tax was determined in two parts. First, Maryland calculated a state income tax. In calculating that income tax, Maryland considered all of the Wynne's income earned in the state of Maryland (including Maxim's Maryland income) and all of the Wynne's income earned everywhere else. For this state-level income tax, Maryland credited the taxes the Wynnes paid on income earned in other states. In other words, the state reduced the Wynne's tax liability dollar-for-dollar for every dollar they paid in taxes to other jurisdictions.

Maryland, however, capped the credits at its own maximum rate. To understand how this cap works, imagine that Maxim earned $100 in profits in California, and paid $20 in taxes to California, for an effective tax rate of 20%. Because the maximum rate on personal income in Maryland was 6%, Maryland would limit the tax credit on

California income to $6. This $6 tax credit, however, would eliminate any Maryland income tax on Maxim's California income.[17]

The state of Maryland also imposed a county-level income tax on Wynne's income for 2006. This county-level tax supported the Howard County government, but because it was authorized and collected by the state, it was considered part of the Maryland state income tax regime. In determining the county-level tax, the Wynnes reported the same income and were allowed the same deductions against income for this county level tax, which Howard County imposed at a rate of 3.2%. However, under Maryland law taxes paid to other jurisdictions were not creditable against this county-level tax.

Arguing that this denial of a tax credit against the county level tax violated Dormant Commerce Clause, the Wynnes filed their Maryland tax return for 2006 claiming tax credits against both the state and county portions of the Maryland income tax. The Maryland Department of Revenue rejected the Wynnes' position and issued them a notice of deficiency for underpaying the county portion of their tax liability. The Wynnes appealed. Both the lower Maryland courts and the Maryland Court of Appeals agreed with the Wynnes that denying a tax credit on the county-level tax was a violation of the Dormant Commerce Clause. The state ultimately appealed to the U.S. Supreme Court.

C. The Supreme Court's Opinion in Wynne

According to the Court, the problem with Maryland's tax scheme is that it all but guaranteed that the Wynnes would pay a higher tax because they earned money outside

[17] At least as determined under Maryland's source rules. To the extent that Maryland and California's sourcing rules conflicted, this regime becomes even more complicated, but the Supreme Court Dormant Commerce Clause jurisprudence typically rejects complaints based on discrepancies in sourcing rules.

of the state than they would have paid had they earned all of their income in the state. For the majority, this represented unconstitutional discrimination against interstate commerce.

In what proved a persuasive brief to the Court, Professors Michael Knoll and Ruth Mason argued that Maryland's county taxing scheme violated the second prong of *Complete Auto* because it failed the internal consistency test.[18] Under the internal consistency test, the court asks whether "the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear."[19] As the Court noted in *Jefferson Lines*, internal consistency "asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate."[20]

In their *Wynne* amicus brief, Knoll and Mason suggested that the internal consistency test be evaluated by looking at what would happen to the tax burden on in-state and out-of-state business if Delaware (a stand-in for any state) adopted the same scheme as Maryland. In creating the comparison, Knoll and Mason used the highest potential county tax rate on resident's in-state activity (3.2%) and the tax rate Maryland imposed under the county tax for non-resident, Maryland-source income (1.2%).[21]

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[18] Brief of Michael S. Knoll and Ruth Mason as Amici Curiae in Support of Respondents at 2, Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787 (2015) (No. 13-485) 2014 WL 4895269, at *2; Brief of the Tax Economists as Amici Curiae in Support of Respondents at 23–24, Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787 (2015) (No. 13-485) 2014 WL 4895266, at *23–24.
[19] Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995).
[20] *Id.*
[21] Brief of Michael S. Knoll, *supra* note 18, at 5-6.

Maryland Tax Under Knoll and Mason Internal Consistency Test[22]

	Maryland Resident	**Delaware Resident**
Activity in Delaware	4.45%	3.2%
Activity in Maryland	3.2%	4.45%

As illustrated above, under this argument, the Maryland scheme would always result in a higher tax rate imposed on resident-income earned outside the state than resident income earned within the state because resident income earned outside the state would be taxed twice, once by the source jurisdiction (i.e., where the money was earned) and once by the taxpayer’s state of residence.

Mason and Knoll concluded that Maryland had several policy choices to rectify this discrimination.[23] It could provide a credit to offset the taxes paid to other states. Such a regime would not result in discrimination because it would mean income earned outside of Maryland would be taxed at the same rate as income earned in Maryland. It could lower its tax on non-resident income, or it could raise its domestic tax.

The Supreme Court adopted Mason and Knoll’s internal consistency test analysis and gave a very similar example, using a 1.25% tax rate on in-state and out-of-state income, and two taxpayers who live in the same state, one of whom earns income in her state of residency, and the other of whom earns income in a different state.

Maryland Tax Under Court’s Example[24]

[22] *Id.* at 7.
[23] *Id.* at 29.
[24] Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787, 1803–04 (2015) (“Assume that every State imposed the following taxes, which are similar to Maryland's ‘county’ and ‘special nonresident’ taxes: (1) a 1.25% tax on income that residents earn in State, (2) a 1.25% tax on income that residents earn in other jurisdictions, and (3) a 1.25% tax on income that nonresidents earn in State. Assume further that two

	April	Bob
Activity in in State A	1.25%	--
Activity in State B	--	2.5%

In its discussion of the internal consistency test, the court refers explicitly to the economic analyses offered by Knoll and Mason and by a group of tax economists.[25] In particular, the opinion notes that Maryland's counsel had failed to respond to these claims in oral argument.[26]

In dissent, Justice Ginsburg, joined by Justices Scalia and Kagan, argued that the majority's reliance on the internal consistency test does not find support in the Court's Dormant Commerce Clause precedent. As she observed, "Before today, for two decades, the Court has not insisted that a tax under review pass the internal consistency test, and has not struck down a state tax for failing the test in nearly 30 years.[27] To Ginsburg, the court's application of the internal consistency test requires the Court to make policy choices better left to the states themselves: "This case is, at bottom, about policy choices: Should States prioritize ensuring that all who live or work within the State shoulder their fair share of the costs of government? Or must States prioritize avoidance of double taxation?"[28]

taxpayers, April and Bob, both live in State A, but that April earns her income in State A whereas Bob earns his income in State B. In this circumstance, Bob will pay more income tax than April solely *1804 because he earns income interstate. Specifically, April will have to pay a 1.25% tax only once, to State A. But Bob will have to pay a 1.25% tax twice: once to State A, where he resides, and once to State B, where he earns the income.").

[25] *Id.*

[26] Id. at 1804.

[27] *Id.* at 1820–21.

[28] *Id.* at 1823.

In addition, Justice Scalia and Justice Thomas both filed sharply worded dissents. JusticAe Scalia argued that "[t]he fundamental problem with our negative Commerce Clause cases is that the Constitution does not contain a negative Commerce Clause,"[29] and called the doctrine "a judicial fraud."[30] Justice Thomas, noting his past rejection of the negative commerce clause, argued that the majority's opinion "would have come as a surprise to those who penned and ratified the Constitution."[31]

Commentators have been of mixed minds about the impact of *Wynne*. Some, like Walter Hellerstein, have applauded the result, while concluding that there was a simpler way for the Court to reach this result and noting some of the questions left open by the Court.[32] Others, especially state and local tax practitioners, have focused on the potential challenges taxpayers can bring in the wake of *Wynne*. For example, Ernst & Young wrote that taxpayers should consider filing for refund claims in other states.[33]

Part II: Potential Impact of Wynne on Local Tax System

For a case ostensibly about state taxation, a surprisingly amount of the briefing in *Wynne v. Comptroller* focused on the impact the case might have on local jurisdictions. For example, the United States in its brief arguing for the Supreme Court to take certiorari noted that if the Maryland opinion stood, it threatened all local taxes that did not provide full credits for foreign taxes.[34] In fact, it was this impact on local

[29] *Id.* at 1808.
[30] *Id.*
[31] *Id.* at 1812.
[32] Hellerstein, *supra* note 3.
[33] ERNST & YOUNG, SUPREME COURT RULES THAT MARYLAND'S LAW DISALLOWING LOCAL INCOME TAX CREDIT FOR TAXES PAID TO OTHER STATES IS UNCONSTITUTIONAL 4 (2015), http://www.ey.com/Publication/vwLUAssets/Maryland_v._Wynne:_Impact_on_local_taxes/$FILE/EY-maryland-wynne-impact-on-local-taxes.pdf.
[34] Brief for the United States as Amicus Curiae at 19–20, Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787 (2015) (No. 13-485) 2014 WL 1348934, at *19–20 ("The question presented also appears to have importance beyond its effect on Maryland. Respondents do not dispute the existence of more than 2000

governments that formed the thrust of the United States' argument that the case merited Supreme Court review.[35]

Similarly, another amicus brief supporting Maryland's certiorari petition argued that "t]he implications of the [Wynne] ruling for many of those municipalities is dire: if every state is required to accord its residents a dollar-for-dollar credit for all income taxes paid to out of state recipients (including counties and cities in other states), the flow of funds to in-state municipalities will be vastly curtailed."[36] This brief, filed on behalf of the United States Conference of Mayors, the National Association of Counties and other groups interested in local fiscal health, noted that "[t]here are many states with long-established tax programs that, like Maryland's, do not afford dollar-for-dollar credits to residents for all out-of-state income taxes paid and are operating on a premise of constitutional viability."[37]

Other amici suggested that affirming the Maryland opinion would create significant uncertainty for both state and local income tax systems. As the Multistate Tax Commission argued, "[a]nalyzing the interplay of many potentially conflicting state and local government tax systems to determine whether a credit is mandated would require the courts to make legislative value judgments, and could ultimately undermine our system of federalism by limiting state tax policy choices and revenues."[38]

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municipal income taxes nationwide that might not provide credits for out-of-state income taxes. Because "a municipality is merely a political subdivision of the State from which its authority derives" those municipal taxes could be invalidated if courts in the relevant jurisdictions find the reasoning of the decision below persuasive." (internal citations omitted)); *see also* Reply Brief for the Petitioner at 4–5, Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787 (2015) (No. 13-485) 2014 WL 5449617, at *4–5.

[35] Brief for the United States, *supra* note 34.

[36] Brief of the Int'l Mun. Lawyers Assoc., the U.S. Conference of Mayors, the Nat'l Assoc. of Ctys., the Int'l City/Cty. Mgmt. Assoc. and the Md. Assoc. of Ctys. as Amici Curiae in Support of Petitioner at 3, Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787 (2015) (No. 13-485) 2014 WL 6115820, at *3.

[37] *Id.*

[38] Brief for Multistate Tax Comm'n, *supra* note 3, at 3–4.

At oral argument, Justice Kagan asked about the impact of the Maryland decision on other local governments,[39] but no other justice seemed particulary interested in the impact of the decision beyond Maryland.

The majority opinion does not address any of these issues. Instead the Justices focused on an economic analysis of the Dormant Commerce Clause. Lost in these theoretical arguments are the practical effects of the decision. In this Part, I will first look at local income taxes and the role they play in local finance. I will then turn to addressing *Wynne*'s potential impacts on these decisions.

A. Local Income Taxes

One of the challenges of discussing "local government" generally, and local finance in particular, is that states vary a great deal in the revenue options they grant to local governments. However, some general observations can be made about local "own-source revenue," i.e. revenue the locality receives from user fees and taxes as opposed to money from intergovernmental grants or borrowing.

The property tax provides local governments with their largest source of own-source revenue.[40] This pattern of tax utilization reflects state grants of revenue authority. While virtually all local governments are authorized to impose property taxes, fewer have

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[39] Transcript of Oral Argument at 26, Comptroller of Treasury of Md. v. Wynne, 135 S. Ct. 1787 (2015) (No. 13-485) ("If we were to rule against Maryland, how many States are in the same position as Maryland, either because they do a county tax themselves or because they allow local jurisdictions to impose their own taxes?"); *Id.* at 33.

40*State and Local Tax Policy: What Are the Sources of Revenue for Local Governments?*, TAX POLICY CTR., http://www.taxpolicycenter.org/briefing-book/state-local/revenues/local_revenue.cfm (last visited Nov. 2, 2016). Mining data on municipal revenue sources is a tricky business, however. There are some authorities who believe user fees now eclipse property taxes. Michael A. Pagano, *United States of America*, *in* LOCAL GOVERNMENT AND METROPOLITAN REGIONS IN FEDERAL COUNTRIES 363, 375 (Nico Steytier & John Kinkaid eds., 2009).

sales tax authority, and only a fraction have income tax authority.[41] As a result, about half of municipal governments receive sales tax revenue, while the National League of Cities estimates that only about ten percent of municipalities receive revenue from income or wage taxes[42] In addition, in some state, counties and school districts also impose income taxes.[43]

In minimizing the potential impact of striking down Maryland's tax scheme, the taxpayers were in some sense right. As a portion of overall local government revenue, income taxes play only a minor role in balancing the government checkbook. Nevertheless, for those jurisdictions that have adopted local income taxes, the stakes can be quite high. In this section, I look at the role of local income taxes in particular jurisdictions in more depth.

1. Pennsylvania

The 1932 Sterling Act granted Philadelphia the power to "tax anything the State itself can tax so long as the State is not taxing the objects which the city proposes to tax."[44] Facing a massive revenue shortfall due to declining property taxes, Philadelphia imposed the nation's first city income tax in the midst of the Great Depression.[45] At the time Pennsylvania did not have a state income tax.[46]

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41 *See* NAT'L LEAGUE OF CITIES, CITIES AND STATE FISCAL STRUCTURE 16 tbl.1A (2015), http://www.nlc.org/Documents/Find%20City%20Solutions/Research%20Innovation/Finance/NLC_CSFS_Report_WEB.PDF (summarizing available municipal taxing authority); Joseph Henchman & Jason Sapia, *Local Income Taxes: City- and County Level Income and Wage Taxes Continue to Wane*, TAX FOUND. (Aug. 31, 2011), http://taxfoundation.org/article/local-income-taxes-city-and-county-level-income-and-wage-taxes-continue-wane.

42 MICHAEL A. PAGANO & CHRISTIANA MCFARLAND, CITY FISCAL CONDITIONS IN 2013, at 3 (2013).

43 Henchman & Sapia, *supra* note 41.

44 Jewell Cass Phillips, *Philadelphia's Income Tax After Twenty Years*, 11 NAT'L TAX J. 241, 244 (1958).

45 *Id.* at 241.

46 Pennsylvania adopted its sate income tax in 1971. Scott Drenkard, *When Did Your State Adopt Its Income Tax?*, TAX FOUND. (June 10, 2014), http://taxfoundation.org/blog/when-did-your-state-adopt-its-income-tax.

In 1965, the Local Tax Enabling Act expanded the local taxing power beyond Philadelphia, permitting many local governments to assess taxes, "as shall Philadelphia on persons, transactions, occupations, privileges, subjects and personal property."[47] However, the Local Tax Enabling Act expressly denied localities the abilities to assess certain taxes other than income taxes.[48]

When Pennsylvania finally adopted a statewide personal income tax in 1971, it included a savings clause that provided continuing authorization for local income taxation.[49] Over the years, there have been reforms to Pennsylvania's local income tax regime. Some of these reforms tied local income tax authority to reductions in local property taxes.[50][51] In 2008, Pennsylvania attempted to bring uniformity to these local income taxes by standardizing definitions of important terms and rules[52] and restricting local use of income tax revenue.[53] In addition, the act simplified administration of the local income tax.

Employers withhold the EIT from employees who either work or live in the Commonwealth. If the employee both lives and works in Pennsylvania but in different

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[47] Local Tax Enabling Act, 53 PA. CON. STAT. §§ 6901–6924 (1965). The Act applied to "cities of the second class, cities of the second class A, cities of the third class, boroughs, towns, townships of the first class, townships of the second class, school districts of the second class, school districts of the third class, and school districts of the fourth class." *Id.*
[48] *Id.* § 6902. Examples of prohibited taxes include transfer of property from will, mortgage, intestacy and similar property transfers; Pennsylvania regulated fixed rate utility services; sales to "places of amusement"; wages or salaries of nonresidents in school districts of second, third, and fourth classes; and other such limitations. *Id.*
[49] Tax Reform Code of 1971, 72 PA. CON. STAT. §§ 7101–8203 (1971).
[50] In 1988, Act 50 authorized school districts to impose an earned income tax (EIT) of up to 1.5% for the purpose of reducing property taxes after following the prescribed requirements. Joseph C. Bright, *Earned Income Tax: Rate and Sharing*, *in* 27 SUMM. PA. JUR. 2D TAXATION § 17:16 (2d ed. 2016) (citing 53 PA. CON. STAT. §§ 8701–8717).
[51] In 2001, Act 24 allowed the school districts to increase the EIT if the increase received voter approved. PA. GOVERNOR'S CTR. FOR LOCAL GOV'T SERVS., ACT 32 OF 2008: POLICY AND PROCEDURE MANUAL (2013) http://dced.pa.gov/download/act-32-of-2008-procedure-manual/?wpdmdl=56767 [hereinafter ACT 32 MANUAL].
[52] S. 1063, 2008 Gen. Assemb. A-32 (Pa. 2008).
[53] Act 32 limited how the revenue could be used to emergency services, roadways, reduction and/or relief from property taxes with limitations and exceptions. *Id.*

PSD districts, the higher of the two EIT rates is applied.[54] Employees who live in Pennsylvania, but do not work within the state are subject to the resident rate based on their home address's EIT rate; employees who work in Pennsylvania but do not live in the state are subject to their work location's non-resident EIT rate.[55] Philadelphia has its own separate city wage tax and system with its own Earnings Tax.[56]

For Pennsylvania local governments as a whole, the local income tax represents only a small portion of revenue, accounting for only 8% of revenue.[57] For Pennsylvania counties, however, income taxes play a bigger role. [Still trying to track down data.] Philadelphia's income tax, known as the Philadelphia Wage Tax, brought in 33% of the city's total revenue and 45% of the city's tax revenue in Fiscal Year 2014.[58]

[Summaries of other jurisdictions to come]

For these local jurisdictions, *Wynne* raises a host of questions, to which we will now turn.

B. State Crediting of Local Income Taxes After *Wynne*

Of course the most immediate impact of *Wynne* is on Maryland and its county governments. As of September of last year, Maryland had paid out $36.3 million in refunds and interest, and that amount reflected claims on the 20% of received claims that

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[54] Frank Czekay & David F. Werner, *Local Earned Income Tax Changes for Employers Under Act 32*, J. MULTISTATE TAX'N & INCENTIVES, Jan. 2012, at 37.
[55] *Id.*
[56] *Payments, Assistance & Taxes,* CITY OF PHILA., https://beta.phila.gov/services/payments-assistance-taxes/income-taxes/earnings-tax-employees/ (last visited Nov. 3, 2016).
[57] State & Local Government Finance Data Query System. http:// www.taxpolicycenter.org/slf-dqs/pages.cfm. The Urban Institute-Brookings Institution Tax Policy Center. Data from U.S. Census Bureau, Annual Survey of State and Local Government Finances, Government Finances, Volume 4, and Census of Governments (last visited X).
[58] CITY OF PHILA., SUPPLEMENTAL REPORT OF REVENUES & OBLIGATIONS: FISCAL YEAR ENDED JUNE 30, 2014 http://www.phila.gov/finance/pdfs/FY14%20Supplemental.pdf.

had been processed.[59] At the time, Maryland said that claims were "coming in faster that [the state was] getting them processed,"[60] and that the state was anticipating more refund claims, in part because in the wake of *Wynne*, the comptroller decided not only to credit state tax paid against the county-portion of the Maryland income tax (as clearly required by *Wynne*), but also to credit local income taxes paid. Some of those who had already gotten refunds and filed their refund claims prior to the decision to credit local income taxes filed again.

But while lawyers and amici for *Wynne* tried to argue that its applicability would be limited, the case raises questions for many jurisdictions. After *Wynne*, some states, such as Kansas, have followed Maryland's example and granted credits against local income taxes paid in other states.[61] However, not all states have followed suit. Virginia for example has resisted granted credits against local taxes paid to other jurisdictions, on the theory that because Virginia does not have a local income tax, such a credit is not required by the internal consistency test.[62] And it's not just state income taxes that are affected. The Supreme Court of Appeals of West Virginia recently heard two challenges to its state motor fuel use tax for failing to credit local fuel use taxes.[63]

B. Local Governments May Also Need to Reform Their Taxes in the Wake of Wynne

[59] David Sawyer, *Procession of* Wynne *Refunds Backlogged, Maryland Officials Say*, 77 ST. TAX NOTES, Sept. 21, 2015, at 975.
[60] *Id.*
[61] *Kansas DOR Provides Guidance in Response to* Wynne, RSM (AUG. 11, 2015), http://rsmus.com/what-we-do/services/tax/tax-alerts/kansas-dor-provides-guidance-in-response-to-wynne.html.
[62] Sawyer, *supra* note 60.
[63] *Supreme Court of Appeals Argument Docket*, W. VA. JUDICIARY (Oct. 25, 2016), http://www.courtswv.gov/supreme-court/calendar/2016/dockets/oct-25-16ad.html (Martin Distibuting Co v. State Tax Comm'r, Case No. 15-0842 and State Tax Comm'r v. CSX Transportation, Case No. 14-0935).

Local income taxes may also need to respond to *Wynne*. In the wake of *Wynne*, Indiana, for example, now credits local income taxes paid to other jurisdictions against its county-level income tax.[64]

There are already legal challenges underway against Philadelphia's Wage Tax, and challenges to other local income tax structures are likely forthcoming.[65] While New York City's personal income tax does not clearly have a *Wynne* problem because it does not tax non-resident income, James Wetzler has argued that other features of the City's income tax scheme may raise internal consistency problems.[66] New York City's unincorporated business tax (UBT) taxes New York City source income at 4%. For residents, the city provides a credit against its personal income tax return for UBT paid, but the credit is not available for similar taxes paid to other jurisdictions, thus potentially violating the *Wynne* internal consistency test.[67] Wetzler also notes that New York City's two-part definition of resident, which includes both domiciliaries and those present in the City for more than 183 days, may violate the internal consistency test.[68]

Exactly what *Wynne* requires of these local income taxes is unclear. If localities decide to try and solve these internal consistency problem by offering credits against taxes paid to other jurisdictions, do they need to credit taxes paid to both states and localities or would it be sufficient simply to credit local income taxes? As Mason and

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[64] http://rsmus.com/what-we-do/services/tax/state-and-local-tax/income-and-franchise/indiana-extends-credits-for-local-income-taxes-as-a-result-of-wy.html
[65] *See* https://www.law.upenn.edu/live/news/6106-knoll-argues-philadelphia-wage-tax#.WA5GxrxpG2w (discussing these challenges).
[66] James W. Wetzler, Filing Discrimination in New York's Local Income Taxes, State Tax Notes Today (July 21, 2015).
[67] *Id.*
[68] *Id.*

Knoll note, crediting only local taxes paid may leave in place the potential for an internal consistency challenge.[69]

III: Opportunities for Reforming Local Income Taxes in Light of Wynne

Independently of *Wynne*, there is a long history of criticism of local income taxation. In the wake of *Wynne*, and taxpayer lawsuits challenging local income taxes, there may be opportunities for reform.

In some sense, *Wynne* highlights the tension between good constitutional law and good policy arguments. In many ways, Maryland's county income tax was a model of how a local income tax should be implemented. Localities had no control over the income tax base. Rather, under Maryland law, counties could only control the tax rate, which ranged from a high of 3.2% to a low of 1.25%. In other words, the county tax really operated as a surtax on income.

By giving localities control over the rate, but not the base, Maryland law gave local government meaningful control over its fiscal affairs while ensuring ease of compliance and minimizing intra-Maryland base competition. Further, because the county tax was based primarily on residence and not on source, the law did not require complicated sourcing rules to determine whether income was appropriately sourced to a specific county. For residents, the tax applied to all income. For non-residents, the supplementary county tax applied to all income reported on the non-resident Maryland state tax return.

Both of these simplifications are important. New York City's UBT affects only New York City *source* income, which means taxpayer with New York City income and

[69] ; https://www.law.upenn.edu/live/news/6106-knoll-argues-philadelphia-wage-tax#.WA5GxrxpG2w. Pg. 176 N. 55.

income from other parts of New York State must track the source of that income whicallowed cities to deviate not only from the state income tax base but also each other's tax base, and the municipal definition of residency differed from the state's residency definition. After decades of simplification efforts, Ohio's municipal income tax reform went into effect this year. While municipal tax bases are now much more uniform, the harmonization is not perfect. Ohio's municipalities are not required to provide a credit for taxes paid to other jurisdictions, though most do. While one could litigate an internal consistency Dormant Commerce Clause challenge against Ohio's local income taxes, that challenge likely does not address the bigger policy problem with these local taxes, which is imperfect uniformity with the state tax code.[70]

As discussed previously, some states have preemptively sought reforms to bring them in compliance with *Wynne*. Not all such reforms, however, are necessitated by *Wynne*. Iowa, for example, has long had a non-discriminatory income tax supporting counties and local schools. Because Iowa's tax only applied to residents, it never violated the internal consistency test.[71] However, Iowa lawmakers, perhaps misreading *Wynne*, believed that tax credits had become a constitutional requirement, and thus reformed Iowa's local income tax system to provide credits for taxes paid to other jurisdictions.

But while many in the private bar may see *Wynne* as an opportunity to challenge local tax laws, others have seen the case as an opportunity for reform. For example, Ruth

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70 http://www.bricker.com/industries-practices/taxation/insights-resources/publications/supreme-court-decision-in-comptroller-v-wynne-raises-questions-regarding-ohio-school-district-and-municipal-income-taxes; http://blog.wvco.com/2015/12/01/did-ohio-residents-just-wynne/

71 I am grateful to Adam Thimmesch for bringing Iowa's reforms to my attention.

Mason and Michael Knoll have argued that challenges to Philadelphia's Wage Tax provide an opportunity to rethink that tax.

State and local governments should respond to *Wynne*'s mandate in two ways. First, they should litigate some of the issues implicated by a broad reading of *Wynne* in an effort to stem revenue loss. However, in some instances preemptively modifying laws to bring them into compliance may be the preferable strategy. Preemptive action will give the local government more control over the *Wynne* remedy (and therefore the revenue cost of the remedy). As James Wetzler notes, for example, New York City could reform its residency definition to solve the internal consistency problem with potentially only a "little revenue cost."[72] Second, cities and local governments should use *Wynne* to spur needed reforms.

A. Limiting *Wynne*

One of the difficulties Maryland faced before the Supreme Court was that it was the only state that failed to offer any tax credits against its (county-level) state income tax. At oral argument, advocates tried to press the point that constitutionalizing this credit requirement might present problems for even states that have tax credits, but this argument made for an uphill battle. As a result the majority opinion often assumes that Maryland is an outlier and that finding its statute violates the Dormant Commerce Clause will have only a modest effect on other jurisdictions. Unfortunately, this is not necessarily the case.

Even though Maryland was the only state to outright refuse to provide a credit for state income taxes paid, many states limit their credits in one way or another.[73] No state

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[72] Wetzler, *supra*
[73] State Resident Tax Credits After the *Wynne* Decision, Tax ABA Fall Meeting, September 17, 2015.

provides credits against taxes paid to foreign governments or taxes calculated with reference to income (like gross receipts taxes, Washington's B&O tax, or margins taxes). Some states only grant credits for state income taxes and not local income taxes. Other states limit credits for taxes paid at the entity level or limit the credit to the state's maximum tax rate.

While some of these limits may be unconstitutional under *Wynne*, states and local governments should seek to limit the impact of *Wynne*. Among other things, states and localities should ensure that only a narrow range of local taxes are deemed income taxes and thus subject to credit requirements.

B. Reforming Local Income Taxes

As the example of Iowa suggests, *Wynne* is spurring changes to local income taxes, even when those changes may not be required by law. The need to reconsider local income taxes to in light of *Wynne* provides state and local governments with an opportunity to think more broadly about local income tax policy.

Reforming local taxes is difficult to do, in part because it requires coordination between state and local governments. For example, though the the state has the legal authority to reform Ohio's municipal tax base, reform efforts were stalled for years because of strong municipal interest in the status quo and concerns that other taxes would be raised if reforms resulted in lower revenue flowing to Ohio's local governments. Further, different localities within a given state may have different reform priorities, thus making compromise more difficult.

The fact that *Wynne* may constitutionally require reforms (or at least be perceived to require such reforms) may put some wind in the sails of reform efforts. While not required by *Wynne*, such reforms should prioritize harmonizng local and state income tax bases and simplyfing the administratiion of these taxes by giving greater administrative authority to state revenue agencies. Finally, to the extent *Wynne* necessitates reforms that reduce local government revenue, states should work with localities to ensure that revenue is replaced.

Conclusion

While local governments continue to rely primarily on property and sales taxation, local income taxes support a significant number of cities and counties, ranging from New York City to Lake County, Indiana. In fact, local income taxes are surprisingly common. Over 2000 jurisdictions impose them.

Wynne's decision offers an opportunity to revisit local income taxes. In thinking about the implications of *Wynne*, I hope to underscore the opportunities *Wynne* creates for focusing renewed attention on local income taxes. At a time when local governments are searching for broader sources of revenue, understanding how to reform local income taxes consistent with *Wynne* will prove important, and if *Wynne* spurs other policy reforms to local income taxes, so much the better.