

COULD MARYLAND V. WYNNE RESULT IN NY REFUNDS?

State & Local Tax Alert
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A new U.S. Supreme Court case, *Maryland v. Wynne*, will likely have a broad impact on various state taxation schemes, and it could create the potential for refunds for numerous taxpayers. Taxpayers who have paid tax to multiple states on the same income should consider submitting protective refund claims as a result of the holding in this case. Below we review the case, as well as those situations that could give rise to a refund.

The Wynne Case

Last month, the court declared Maryland's resident tax credit structure unconstitutional because it subjected income earned outside the state by residents to potential double taxation. The Supreme Court concluded in a 5 to 4 decision that this structure impermissibly favored income earned within Maryland over income earned outside the state. According to the court, this effectively created a tariff that violated the dormant Commerce Clause of the U.S. Constitution.

Here's a quick review of the facts of the case: Brian and Karen Wynne are Maryland residents. Like most states, Maryland taxes residents on their worldwide income regardless of whether its source is from within or outside Maryland. In 2006, Brian Wynne owned stock in a Subchapter S corporation that operated, earned income, and filed tax returns in 39 states. As a result, the Wynnes paid income tax in Maryland and in many other states. The Wynnes reported all of the income that flowed through to them from the S corporation on their Maryland income tax returns but claimed an offset against their Maryland tax for taxes paid to other states through the application of Maryland's "resident tax credit." Almost every state tax code contains a similar credit. These credits are designed to avoid double taxation and to allow for the proper allocation of the tax burden to the jurisdiction where the income was earned.

The problem in the case arose because Maryland imposed two income taxes, a state tax and a county tax. Despite imposing two taxes, the Maryland resident credit for taxes paid to other states applied only to the state tax, not the county tax. Thus, the Wynnes ended up being double taxed on the S corporation income to the extent of the county tax. They paid tax to the states where the income was earned, and they paid the Maryland county tax on the same income. According to a majority of the Supreme Court, this scheme violated the dormant Commerce Clause of U.S.

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Constitution.

New York Issues?

As attorneys who frequently deal with the New York Tax Law, we can think of several situations that could be impacted by the decision:

- Like Maryland, New York taxes residents on worldwide income and imposes a few local income taxes (i.e., in New York City and Yonkers). In addition, New York's resident credit scheme is similar to the Maryland scheme that was deemed unconstitutional, except, instead of not allowing a credit for taxes paid to other jurisdictions against county tax, New York doesn't allow a credit against tax paid to New York City or Yonkers. But there are significant differences between New York's tax model and that of Maryland. For example, Maryland also imposes their local tax on nonresidents; New York does not impose the New York City tax on nonresidents. That might cause a court to view the New York City situation much differently. And in any case, the impact of this is probably pretty low, given how high the New York State tax rate is before New York's local taxes are considered. Very rarely does a New York City resident taxpayer have source income in another state getting taxed above New York's state-wide rate of 8.82 percent. One obvious example would be a New York City resident with source income in California, which imposes a tax rate of around 13 percent. That taxpayer might consider mounting a challenge against the New York scheme after *Wynne*. On the other hand, Yonkers imposes an income tax on nonresidents, and Yonkers residents paying tax to jurisdictions outside New York State may find that *Wynne* gives them strong support for a refund claim.
- Double taxation also frequently occurs with respect to investment income earned by New York statutory residents. Here's a typical scenario: A Connecticut domiciliary commutes to work in New York City five days per week. The Connecticut resident also maintains a vacation house in the Hamptons. Under these facts, the Connecticut resident will be taxed as a resident of both Connecticut and New York. This is because the taxpayer has his home in Connecticut and owns a house in New York and spends more than 183 days in New York for work. As both a Connecticut and New York resident, the taxpayer will pay tax in both states on wages earned in New York. But Connecticut will allow a credit for taxes paid to New York on the New York wages, effectively subjecting the wage income to only one tax. However, as we've outlined in the past, both Connecticut and New York will seek to tax "intangible" income with neither state providing a credit for taxes paid to the other state. "Intangible" income typically includes investment income such as interest, dividends, capital gains on the sale of stock, etc. New York's highest court held that this structure was constitutional in the 1998 *Tamagni* case, but taxpayers may seek to overturn *Tamagni* based on the Supreme Court's decision in *Wynne*.
- New York is one of only five states that imposes a "convenience of the employer" rule. This rule affects nonresident telecommuters who work for a New York employer from home, outside the state. New York takes the position that all of these days constitute New York workdays, subjecting all wages to tax even if the employee was physically present in another state on most days. And most other states, such as Connecticut, will not allow a credit in this situation because they follow a "physical presence" rule, taxing workdays based on where the employee actually was. Might this be impacted by *Wynne*? Possibly, especially if New York were to insist that in the opposite situation, an out-of-state resident working in a New York vacation home for his own convenience would be required to pay tax to New York under a "physical-presence" rule. That situation might illustrate that the New York rule violates the internal consistency test

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identified by the Supreme Court in *Wynne*. Under that test, a state tax is unconstitutional if assuming every state applied the same tax, there would be double taxation.

Refunds?

So the question is, will *Wynne* impact these double-tax situations? The answer is still up in the air.

Generally, refunds are available within three years from when a tax return was filed or two years from when the tax is paid, *whichever is later*. So taxpayers who have paid taxes as a result of an audit could still have an open statute of limitations, provided their matter was resolved in such a way that preserved potential rights for refund.

So at a minimum, if you've paid double taxes on intangible income as a result of being classified as a statutory resident, pay close attention to what happens in future litigation, which may not be far away. If the statute of limitations for claiming a refund is upon you, a refund claim (which, in New York, must be applied for via an amended return) is probably advisable.

The same goes for those limited number of taxpayers who are affected by New York City's failure to provide for resident credits. Again, it doesn't appear that there is any automatic refund right in light of *Wynne*, but there at least now is a question that some New York court is sure to be asked. So stay tuned, and file protective claims if needed. Certainly Yonkers residents paying taxes in jurisdictions outside of New York ought to file refund claims.

What about convenience-rule cases? Again, more of the same. Stay tuned on this one as well. Though there has been significant commentary on *Wynne*, nobody is really talking about this convenience issue being implicated. We think, however, that if New York continues to insist on the use of a physical presence rule for nonresidents working in New York instead of a "reverse-convenience" rule, the whole scheme could be called into question.

Please contact one of our partners, listed in the sidebar, with specific questions. And if you'd like even more information, listen in on Friday, June 19, from 1-3 p.m. EST as Tim Noonan presents "State Resident Tax Credits after the *Wynne* Decision" in a live CCH webinar. [Click here to register!](#)