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In this installment of SeeSALT Digest, the authors examine how recent taxpayer court victories in Utah and Louisiana on grounds similar to those in the *Wynne* decision could make some provisions in the Tax Cuts and Jobs Act susceptible to challenge.

Introduction

Three years ago, the U.S. Supreme Court invalidated a portion of Maryland's personal income tax scheme on grounds that it violated the dormant commerce clause of the U.S. Constitution. In *Comptroller of the Treasury of Maryland v. Wynne*,[1] the Court held that Maryland's credit mechanism for income taxes paid to other states impermissibly discriminated against interstate commerce because it allowed a credit against state taxes paid but not county taxes, resulting in double taxation on some income earned outside the state.

Since the *Wynne* decision, taxpayers across the country have brought dormant commerce clause challenges against other states' taxing schemes on similar grounds and to similar effect. Recent rulings suggest that *Wynne*'s reach is broadening, and that taxpayers affected by states imposing limitations on credits for taxes paid to other states or countries are in a good position to challenge those limitations.

Recent taxpayer victories in this area also suggest that the implementation of some Tax Cuts and Jobs Act provisions may be ripe for challenge. To the extent that states attempt to tax income previously or simultaneously taxed by foreign countries, for example, the recent dormant commerce clause decisions may serve as a roadmap to thwart such attempts. In particular, the TCJA's provisions providing for a repatriation transition tax, taxation of global intangible low-taxed income, and taxation of foreign-derived intangible income present issues that states must grapple with if conforming to these TCJA provisions.

The Dormant Commerce Clause and *Wynne*

The Constitution affirmatively grants Congress the power "to regulate Commerce with foreign Nations, and among the several States."[2] Beyond this positive grant of power, the Supreme Court has "consistently held this language to contain a further, negative command, known as the dormant commerce clause, prohibiting certain state taxation even when Congress has failed to legislate on the subject."[3] Specifically, the dormant

[1] 135 S. Ct. 1787 (2015).

[2] U.S. Const. Art. I, section 8, cl. 3.

[3] *Oklahoma Tax Commission v. Jefferson Lines Inc.*, 514 U.S. 175, 179 (1995).

commerce clause prohibits discrimination against and undue burdens on interstate commerce.[4]

A state tax will survive a dormant commerce clause challenge if it meets a four-prong test: "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."[5] Fair apportionment, in turn, has two components: internal consistency and external consistency.[6] The internal consistency test requires the apportionment formula to be "such that, if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed."[7] The external consistency test, in contrast, is that "the apportionment formula must actually reflect a reasonable sense of how income is generated."[8] While the internal consistency test arose in the context of determining fair apportionment, the Supreme Court has used it to determine whether the "'identical application'" of a tax in all other states "'would place interstate commerce at a disadvantage as compared with commerce intrastate'" (that is, suggesting internal inconsistency could indicate a violation of *Complete Auto*'s discrimination prong).[9]

In *Wynne*, the Court applied the internal consistency test to determine whether Maryland's personal income tax scheme discriminated against interstate commerce by subjecting it to a higher tax than would be collected if the commerce were solely intrastate.[10] Maryland provided its residents a personal income tax credit for taxes paid to other states against their state income tax but not against their county income tax.[11] The taxpayers were Maryland residents who owned stock in an S corporation earning income and filing state income tax returns in multiple states.[12] The taxpayers claimed a credit for the income taxes paid to other states against their taxes paid to Maryland and their county of residence.[13] The comptroller allowed the credit for the portion of the income tax paid to the states but disallowed the credit against county taxes.[14]

The case came before the Supreme Court to decide the constitutionality of Maryland's income tax scheme. "By hypothetically assuming that every State [had] the same tax structure" as Maryland and by using a "simple example" to "illustrate . . . the point," the Court demonstrated how Maryland's scheme failed the internal consistency test by subjecting a Maryland resident's interstate business income to two states' tax regimes absent a full credit and ultimately taxing it twice.[15] Consequently, the Court held that Maryland's scheme impermissibly discriminated against interstate commerce in violation of the dormant commerce clause.[16] The majority in *Wynne* also put to rest the issue whether a state may burden its own residents with unduly high taxation — and clearly affirmed over the principal dissent's objection that a state must apportion even its own citizens' taxes.[17]

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[4] *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992).

[5] *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977).

[6] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

[7] *Id.*

[8] *Id.*

[9] *Wynne*, 135 S. Ct. at 1802, quoting *Jefferson Lines*, 514 U.S. at 185; *see also Armco Inc. v. Hardesty*, 467 U.S. 638, 644 (1984).

[10] *Wynne*, 135 S. Ct. at 1803-04.

[11] *Id.* at 1792.

[12] *Id.* at 1793.

[13] *Id.*

[14] *Id.*

[15] *Id.* at 1803-1804.

[16] *Id.* at 1792. The Court's use of the internal consistency test — typically applied in the context of fair apportionment — in determining discriminatory treatment has left taxpayers and practitioners to speculate about the potential effects of *Wynne* on *Complete Auto*'s discrimination prong.

[17] *Id.* at 1797.

Utah Goes International

In early 2018 the Third Judicial District Court in Utah extended the reasoning in *Wynne* to questions of foreign commerce.[18] In *Steiner v. Utah State Tax Commission*,[19] the district court applied the internal consistency test for impermissible discriminatory double taxation used by the Supreme Court in *Wynne* to hold Utah's tax structure invalid under the foreign commerce clause of the U.S. Constitution. Specifically, the court found that the structure was not internally consistent as applied to the taxation of foreign business income because it provided a credit for taxes paid to other states but not for taxes paid to other countries.[20]

The taxpayers in *Steiner* were Utah residents and shareholders of a Nevada S corporation that, through a disregarded subsidiary, engaged in a textile rental business that generated income from activities within Utah, interstate activities, and foreign business subsidiaries.[21] The corporation had facilities in 30 states and at least 13 countries.[22] Approximately 2 percent of the corporation's business income was apportioned to Utah during the 2011, 2012, and 2013 tax years, with the remaining 98 percent to other states and countries.[23]

On their 2011, 2012, and 2013 Utah personal income tax returns, the taxpayers claimed a credit for taxes paid to other states on their flow-through income under Utah Code section 59-10-1003.[24] Because Utah does not provide a similar credit for taxes paid to foreign countries, the taxpayers claimed equitable adjustments under Utah Code section 59-10-115 — a mechanism for preventing double taxation — to remove all foreign income from their Utah taxable income.[25] The tax commission disallowed the equitable adjustments at audit and issued deficiencies accordingly.[26]

Before the Utah district court, the taxpayers argued that the state's tax structure impermissibly discriminated against foreign commerce by not providing a credit for taxes paid to foreign countries. In evaluating the taxpayers' claim, and following the Supreme Court's lead in *Wynne*, the district court applied a hypothetical scenario replicating Utah's current structure in all other jurisdictions — both other states and foreign countries — to test whether Utah's scheme was internally consistent.[27]

Comparing three hypothetical resident Utah businesses — one earning income in Utah, another earning income in Colorado, and a third earning income in Germany — and applying Utah's tax structure, the court concluded that the business earning income in Germany would pay a double tax on income earned in that country because while Utah taxed the income of a resident business on its income everywhere, it did not permit the same business to take a tax credit for tax paid to Germany.[28] Accordingly, the court found that the structure discriminated against foreign commerce in violation of the foreign commerce clause and that Utah's equitable adjustment provision applied to avoid a double tax detriment regarding the taxpayers' foreign business earnings.[29]

The question whether a state's provision of a credit for taxes paid to other states but not to other countries violates the foreign commerce

[18] Although state taxes on the instrumentalities of foreign commerce are subject to commerce clause scrutiny, the Supreme Court has been less than precise in delineating the tests applicable under the foreign commerce clause. *See Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 444-449 (1979) (holding that a tax on foreign commerce also must not create a substantial risk of international multiple taxation and must not prevent the federal government from "speaking with one voice when regulating commercial relations with foreign governments"). Accordingly, many have been left to assume that the same analysis applied to interstate domestic commerce applies under the foreign commerce clause.

[19] Case No. 170901774 (Jan. 30, 2018).

[20] *Steiner* at 7.

[21] *Id.* at 1; *see also* Utah State Tax Commission Appeal No. 15-235, Findings of Fact, Conclusions of Law, and Final Decision, at 3.

[22] Utah State Tax Commission Appeal No. 15-235, Findings of Fact, Conclusions of Law, and Final Decision, at 3.

[23] *Steiner* at 1.

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.* at 7.

[28] *Id.*

[29] *Id.* at 7, 14. The district court also concluded that Utah's tax structure did not violate the fair apportionment prong of the *Complete Auto* test and satisfied the external consistency test. *Id.* at 10. The court rejected the taxpayers' arguments that the tax structure was improper "because it may result in a tax liability greater than the total business income generated in the State of Utah or in an effective tax rate that is disproportionately high in relation to the business income generated in the state." *Id.*

clause has arisen before. However, the few courts that have addressed the question determined that the facts at issue in those cases did not implicate foreign commerce at all. A California Court of Appeal, for example, dismissed a challenge in which the resident taxpayers merely were entitled to a share of profits generated by a partnership law office in Japan.[30] Under those circumstances, the California court concluded that "the taxpayers [were] not engaged in 'foreign commerce' merely because they receive[d] income from a foreign source."[31]

The Kansas Supreme Court dismissed a similar claim on related grounds in which a taxpayer held general interests in partnerships owning income-producing commercial real estate, farmland, and timber in the former Czechoslovakia.[32] Despite the taxpayer establishing that he actively managed his partnership interests from both Czechoslovakia and Kansas, the Kansas court held that the taxpayer nevertheless failed to carry his "burden of showing by clear and cogent evidence that the state tax at issue implicates foreign commerce."[33]

The *Steiner* decision not only answered the aforementioned question directly (and in the affirmative), but it extended *Wynne* directly into questions of foreign commerce. Notably, the Utah State Tax Commission argued that such an extension was "unwarranted," but the district court concluded that there was "no persuasive authority for the argument that *Wynne* must be restricted to questions involving interstate taxation."[34] *Steiner* is pending before the Utah Supreme Court on cross-appeals.[35]

[30] *Tetreault v. Franchise Tax Board*, 255 Cal. App. 2d 277 (1967).

[31] *Id.* at 283-284.

[32] *In re Barton-Dobenin*, 269 Kan. 851 (2000).

[33] *Id.* at 860, 863. In its ruling, the Kansas Supreme Court focused on the nature of the state's income tax and how it was "not imposed upon the taxpayers' travels to the Czechoslovakian Republic, their telephone or mail communications, their consulting or managerial services, or on the transmission of money across international lines." *Id.* at 863. A question remains if this analysis holds water after *Wynne* given the U.S. Supreme Court's focus on where the income subject to tax was generated. In any event, Kansas later amended its credit statute to allow a limited tax credit for taxes paid to foreign nations. Kan. Stat. Ann. section 79-32, 111(a).

[34] *Steiner* at 4-5.

[35] Utah Appellate Docket No. 20180223.

Louisiana's Losing Limitations

Louisiana's high court recently struck down 2015 amendments to the state's personal income tax credit scheme that limited the availability of the credit for taxes paid to other states in *Smith v. Robinson*.[36] Before 2015, Louisiana taxpayers received a "full credit" for the payment of out-of-state net income taxes under the governing statute.[37] Under Act 109 and the resulting amendments, however, a credit for taxes paid to another state was allowed only if that other state offered a reciprocal credit.[38] Further, the amount of the credit was "limited to the amount of Louisiana income tax that would have been imposed if the income earned in the other state had been earned in Louisiana."[39]

The taxpayers in *Smith* were Louisiana residents who owned interests in several limited liability companies and S corporations that engaged in business in numerous states, including Texas.[40] For the 2015 tax year, the taxpayers paid Texas $23,180 in franchise taxes on the Texas-sourced income of their passthrough entities.[41] As Louisiana residents, the taxpayers were subject to Louisiana income tax on all of their income derived inside and outside Louisiana.[42] Accordingly, they claimed a credit for the franchise taxes paid to Texas against their Louisiana income tax.[43] The Louisiana Department of Revenue denied the credit under Act 109.[44] The taxpayers paid the $23,180 under protest and filed a petition for refund, asserting that the limits imposed by Act 109 were unconstitutional under the dormant commerce clause because the limits subjected Louisiana residents to multiple taxation.[45]

[36] No. 2018-CA-0728, 2018 WL 6382118 (La., Dec. 5, 2018); and 2015 La. Acts No. 109 (Act 109).

[37] La. Rev. Stat. section 47:33(A)(1) (2014).

[38] La. Rev. Stat. section 47:33(A)(4).

[39] La. Rev. Stat. section 47:33(A)(5).

[40] *Smith* at *1.

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] *Id.* at *1, *2.

Before the district court, the department argued that the Texas franchise tax was not a tax on net income such that no credit was available at the outset, and that Act 109 did not burden interstate commerce because the state has the power to regulate state income tax.[46] The district court ruled in favor of the taxpayers and the department appealed.[47]

The Louisiana Supreme Court first held that the Texas franchise tax was a net income tax, concluding that it begins with revenue and ends by taxing income also taxable under Louisiana law.[48] The court then turned to the constitutional issue and the taxpayers' specific arguments that "Act 109 violate[d] the second and third prong of the *Complete Auto* test pertaining to the apportionment of the tax and discrimination against interstate commerce."[49] Beginning with the fair apportionment requirement, the court concluded that Act 109 failed the external consistency test.[50] By not allowing a credit for taxes paid on income from sources in Texas, the court held that Act 109 did not apportion the out-of-state income in the first instance and created the potential for multiple taxation of the same income.[51]

Regarding the question of impermissible discrimination against interstate commerce, the court drew heavily from *Wynne*, finding the "reasoning and holding" of the case "instructive and applicable."[52] The court drew on the "critical point" made by the *Wynne* Court in reaching its conclusion that Maryland's tax scheme violated the dormant commerce clause, namely that "the total tax burden on interstate commerce is higher."[53] In like fashion, the Louisiana Supreme Court held that "Act 109's failure to provide a credit results in the double taxation of income that is earned outside Louisiana, that is, interstate commerce, but not intrastate income" because "Louisiana residents who earn interstate income are forced into double taxation on all or a portion of their interstate income, whereas Louisiana residents with only intrastate income are not."[54] While the Louisiana Supreme Court acknowledged the *Wynne* Court's application of the internal consistency test in the context of the discrimination analysis, it did not apply the test directly. Instead, the court compared the "effect of Maryland's tax scheme" with that of Act 109 and found that the act similarly "'creates an incentive for taxpayers to opt for intrastate rather than interstate economic activity'" in violation of the dormant commerce clause.[55] Therefore, *Smith* underscores the viability of *Wynne*'s analysis to find a *Complete Auto* discrimination prong violation.

Smith should serve as a warning to states that impose express limitations on the availability of a credit for taxes paid to other states or countries. Whether by requiring a reciprocal credit in the other state or by capping the credit amount to tax that would have been paid in the home state, these limiting mechanisms necessarily subject a taxpayer to multiple taxation on interstate income. Taxpayers affected by any such limitations now have *Smith* to draw from in seeking a full credit under a state's taxing scheme.

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[46] *Id.* at *2.

[47] *Id.*

[48] *Id.* at *5. Both the district court and the Louisiana Supreme Court relied on *Perez v. Secretary of Louisiana Department of Revenue & Taxation*, 731 So.2d 406 (La. App. 1 Cir. 1999), *writ denied*, 743 So.2d 1256 (La. 1999), which "had already addressed and affirmatively concluded that the Texas franchise tax was an income tax under Louisiana law." *Smith* at *2. Notably, the department had affirmatively acquiesced in the holding of *Perez*, a point that the Louisiana Supreme Court reiterated throughout its decision in highlighting the department's reversal of its position. *Id.* at *4, *6. The department's 180-degree turn is not surprising given its desire to defeat the taxpayers' challenge on statutory grounds with *Wynne* looming over the constitutional question.

[49] *Smith* at *8.

[50] *Id.* at *9.

[51] *Id.* The court did not reach the department's argument regarding internal consistency in the context of fair apportionment, stating that "even if a tax is internally consistent, it must also meet the second component of fair apportionment, i.e., external consistency." *Id.* at *8, citing *Jefferson Lines*, 514 U.S. at 184.

[52] *Smith* at *9.

[53] *Id.* at *11, quoting *Wynne*, 135 S. Ct. at 1805.

[54] *Smith* at *9. The court agreed with the taxpayers' arguments that Act 109 both exposed 100 percent of a Louisiana resident taxpayer's interstate income to double taxation (that is, because Texas did not offer a reciprocal credit, taxpayers with Texas-source income would pay twice) and exposed a portion of a Louisiana resident taxpayer's interstate income to double taxation by limiting the credit "to the amount of Louisiana income tax a taxpayer would have paid if the income had been earned in Louisiana." *Id.* at *9, *10.

[55] *Id.* at *11, quoting *Wynne*, 135 S.C. at 1792.

State TCJA Conformity Implications

Steiner and *Smith* may provide authority and helpful roadmaps for taxpayers seeking to challenge state conformity to provisions of the TCJA that involve foreign commerce. Among other things, the TCJA provides special rules for the transition tax and taxation of GILTI that require specified deferred foreign income and the income of some controlled foreign corporations to be in the respective U.S. shareholders' tax bases. FDII, in turn, allows a special deduction to specified U.S. companies with international customers. All three sets of special rules are expressly limited to domestic businesses.[56] *Steiner* and *Smith* provide a framework and examples to challenge state attempts to conform to these TCJA provisions in whole or in part.

Preliminarily, *Steiner* presents a clear application of internal consistency to invalidate improper state taxation of international businesses. Unlike the cases addressing foreign commerce in the personal income tax context, businesses are far less likely to be stymied by the courts' need to find that a taxpayer is engaged in foreign commerce. Therefore, *Steiner*'s application of *Wynne* to foreign commerce implicates the transition tax's and GILTI's generally harmful effects for domestic businesses with foreign-source income subject to tax under these TCJA provisions. Because *Wynne* clarified that the commerce clause limits a state's attempts to overburden its own citizens and residents, *Steiner* raises the specter that state conformity to the transition tax and GILTI could violate the foreign commerce clause's constitutional limitations on state taxation because of improper treatment of domestic businesses.

Smith broadens *Wynne*'s implications for the TCJA by invalidating state taxes based on discrimination and external consistency. *Smith* serves as a guide for challenging facially discriminatory state tax base calculation rules regardless of the state's apportionment method. State corporate income taxes normally apportion income using single or multifactor formulas rather than through credits, which differentiates standard state corporate income apportionment from the *Wynne* fact pattern.[57] But *Smith*'s reliance on the discrimination prong reduces the relevance of apportionment if a properly apportioned tax is still facially discriminatory. Under the TCJA, only U.S. taxpayers are subject to the transition tax's and GILTI's tax base expansions. Similarly, FDII provides a tax deduction limited to domestic businesses. These provisions contain discriminatory rules to calculate a taxpayer's tax base that arguably cannot be remedied merely because a state tax regime could pass muster under the fair apportionment prong.

Further, *Smith* provides a framework for considering external consistency problems with state apportionment when states conform to the transition tax and GILTI. *Smith*'s use of a hypothetical "universal adoption" analysis to illustrate external inconsistency is particularly useful to challenge states' conformity to particular international provisions of the TCJA. Although state corporate income tax formulary apportionment generally does not violate external consistency principles, the TCJA's expansion of the tax base to include foreign-source income may render formulary apportionment inadequate under some facts, and demonstrating as much will be easier when taxpayers may apply a state's own formulary apportionment regime in place of the varied and uncertain tax regimes foreign countries may apply.

For example, consider a U.S. corporation that owns a German-based CFC conducting the U.S. corporation's German business. Applying a standard formulary apportionment model, the German CFC's property, payroll, and receipts are all sourced to Germany under a taxing state's apportionment rules. Accordingly, Germany could tax all the CFC's business income. Nevertheless, a taxing state that conforms to the transition tax or GILTI may include some of the

[56] Sections 965, 951A, and 250.

[57] Although inclusion of foreign-source income in a state's corporate tax base is not per se invalid, U.S. Supreme Court case law has sanctioned such taxation only in contexts in which domestic and international businesses were subject to consistent tax base calculation and formulary apportionment methods. *See Container*, 463 U.S. 159 (1983).

CFC's income in its tax base even if the state otherwise applies water's-edge principles. External inconsistency even may persist in spite of factor relief if the state's application of the transition tax or GILTI increases the U.S. corporation's state tax burden at all. Specifically, the increased state tax burden would indicate double taxation of the CFC's income — income that is not fairly related to in-state activities.

Conclusion

Steiner and *Smith* will likely have a ripple effect across the state tax landscape. Other states' tax schemes may provide a credit for taxes paid to other states but not to other countries, like Utah, or mirror Louisiana's scheme by imposing limitations on credits for taxes paid to other states. Mississippi regulations, for example, expressly state that the credit for taxes paid to another state "does not apply to taxes paid to any foreign country or to taxes imposed by any city, county or other local taxing jurisdiction."[58] As such, resident taxpayers seeking to challenge those states' regimes now have roadmaps to follow and new authority on which to base their arguments.

Steiner and *Smith* may also be harbingers of cases to come under the TCJA, as the decisions forge pathways for challenging state conformity to new federal tax rules. For example, domestic businesses with foreign operations may consider leveraging *Steiner* and its reasoning (following *Wynne*) to challenge various state provisions that effectively tax foreign-earned income. Also, the Utah district court's application of *Wynne* and the internal consistency test to questions involving foreign commerce may inspire new lines of defense to various state actions taken in response to the TCJA. Specifically, states' varied conformity to the transition tax on repatriated dividends under IRC section 965 implicates a slew of issues involving simultaneously or previously taxed income depending on the state in question. If the lower court decision in *Steiner* stands, a state's particular credit mechanisms will now be one more factor to consider, as well as the effects of the state's regime if applied by a foreign country in which a foreign subsidiary operates.

Finally, *Steiner* and *Smith* reveal that state courts are not limiting *Wynne* to its facts — but are readily embracing and expanding the Supreme Court's reasoning to prevent impermissible discrimination against interstate and foreign commerce. As the dormant commerce clause stirs and *Wynne*'s reach broadens with each successful challenge, taxpayers seeking credit or other relief for taxes paid to other jurisdictions may continue down the pathways laid out in *Steiner* and *Smith*. ■

[58] Miss. Admin. Code 35.III.1.12 section 101 (effective Jan. 7, 2019).