THERE'S SOMETHING ABOUT MARYLAND: THE SPECIAL NONRESIDENT TAX AND WHY STATES SHOULD HAVE WIDER LATITUDE WITH THEIR METHODS OF TAXATION

INTRODUCTION

How much power do states have in determining how to tax individuals who earn income within their boundaries?[1] Furthermore, how does that level of power change when the individual deriving income from within those boundaries resides outside of those same boundaries?[2] In past cases, the Supreme Court referred to its own rulings on tax discrimination as a "quagmire"[3] and "tangled underbrush."[4] Furthermore, many legal scholars have suggested that the issue of tax discrimination needs a more "principled approach" to bring some form of consistency to these cases.[5]

While the Supreme Court has struggled to define tax discrimination, it has taken an increasingly active role in striking

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[1] Ruth Mason and Michael S. Knoll, *What Is Tax Discrimination?*, 121 YALE L.J. 1014, 1017 (2012).

[2] *Id.*

[3] Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450, 458 (1959); *see also* Wardair Can., Inc. v. Fla. Dep't of Revenue, 477 U.S. 1, 17 (1986) (Burger, C.J., concurring in part and concurring in the judgment) (referring to "the cloudy waters of this Court's 'dormant Commerce Clause' doctrine").

[4] Nw. States Portland Cement Co., 358 U.S. at 457 (quoting Wisconsin v. J.C. Penney Co., 311 U.S. 435, 445 (1940)).

[5] Dan T. Coenen & Walter Hellerstein, *Suspect Linkage: The Interplay of State Taxing and Spending Measures in the Application of Constitutional Antidiscrimination Rules*, 95 MICH. L. REV. 2167, 2173 (1997) (considering the treatment of linked tax-and-subsidy schemes under the dormant Commerce Clause).

down states' methods of taxation when it views the method as discriminatory.[6] In doing so, the Supreme Court's rulings have been consistent in agreeing that states may not categorically deny tax deductions to nonresidents.[7] For instance, in *Lunding v. New York Tax Appeals Tribunal,* the Supreme Court held that denying nonresidents their alimony deduction violated the Privileges & Immunities Clause.[8] However, offsetting some of the costs of governing through taxation remains an important need for states.[9]

The Supreme Court has interpreted the Privileges & Immunities Clause as being "designed to insure to a citizen of State A who ventures into State B the same privileges that the citizens of State B enjoy."[10] Furthermore, the Supreme Court has stated that the Privileges & Immunities Clause shields nonresidents as being "*exempt from any higher taxes or excises* than are imposed by the [other] State upon its own citizens."[11] Still, the Supreme Court has declined to lay out a bright line test for determining whether "fairness" exists in a state's nonresident tax.[12] In *Lunding*, the Supreme Court used a "substantial reasons" test to determine that the denial of the alimony deduction violated the Privileges & Immunities Clause because it treated nonresidents differently.[13] In other words, the Supreme Court found that New York failed to show a substantial reason for denying the alimony deduction to nonresidents.[14]

Cases such as *Lunding*, *Frey v. Comptroller of the Treasury*, and *Allied Stores of Ohio v. Bowers* show the complexities and different interpretations courts have dealt with in situations

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[6] Mason and Knoll, *supra* note 1, at 1019.

[7] *Id.*

[8] 522 U.S. 287, 315 (1998).

[9] James Michael Daily, *The Thin Line Between Acceptable Disparate Tax Treatment of Nonresidents and Unconstitutional Discrimination under the Article IV Privileges and Immunities Clause: Lunding v. New York Appeals Tribunal, 118 S. Ct. 766 (1998)*, 21 HAMLINE L. REV. 563, 565 (1998).

[10] *Id.* (citing Toomer v. Witsell, 334 U.S. 385, 395-96 (1948)).

[11] *Id.* (citing Ward v. Maryland, 79 U.S. (12 All.) 418, 430 (1870) (emphasis added)).

[12] David Schmuddle, *Constitutional Limitations on State Taxation of Nonresident Citizens*, L. REV. MICH. ST. U. DET. C. L. 95, 98 (1999).

[13] 522 U.S. at 296.

[14] *Id.* at 315.

where alleged tax discrimination has occurred.[15] These varying interpretations have produced a confounding line of cases that still leave the issue of how to determine if certain taxation methods are discriminatory very much in flux.[16] These and other rulings have called for a reexamination of the way courts approach tax discrimination so that states can have wider latitude in their methods of taxation.[17]

I. BACKGROUND

A. History of Landmark Tax Discrimination Cases and the Privileges & Immunities Clause

In the 1823 case of *Corfield v. Coryell*, the Supreme Court discussed which fundamental privileges and immunities citizens are entitled to "in the several states" under the protection of the Privileges & Immunities Clause.[18] With regard to taxation, the Supreme Court stated that the citizens of other states are entitled to "an exemption from higher taxes or impositions than are paid by the other citizens of the state" under the Privileges & Immunities Clause.[19] Almost a century later, the Supreme Court clarified their stance on the taxation of nonresidents in the landmark tax discrimination cases *Shaffer v. Carter* and *Travis v. Yale & Towne Mfg. Co.*[20]

In *Shaffer v. Carter*, the Supreme Court held that the state of Oklahoma possessed the power to tax nonresidents on income earned within the state of Oklahoma or earned from a business or property within the state's boundaries as long as the tax was not

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[15] Daily, *supra* note 9, at 566.

[16] *Id.* at 567.

[17] *Id.* at 566.

[18] 6 F. Cas. 546, 551 (1823). *Corfield* centered on a trespass action against the defendant for the seizing and carrying away of a ship that was the property of the plaintiff but was in violation of an oyster harvesting law. The Supreme Court examined the Privileges and Immunities Clause to determine the rights of the plaintiff for the seizure of the vessel in the Delaware Bay by New Jersey constables and magistrates. *Id.*

[19] *Id.* at 552.

[20] Shaffer v. Carter, 252 U.S. 37 (1920); Travis v. Yale & Towne Mfg. Co., 252 U.S. 60 (1920).

too burdensome.[21] Additionally, the Supreme Court held that Oklahoma possessed the power to deny nonresidents any business losses that were incurred through out-of-state activities.[22] In its opinion, the Supreme Court stated that state governments "assume and perform the duty of preserving and protecting all such persons, property, and business, and, in consequence, have the power normally pertaining to governments to resort to *all reasonable forms of taxation* in order to defray the governmental expenses."[23] In *Travis v. Yale & Towne Mfg. Co.*, the Supreme Court simply held that a state does not possess the power to deny personal exemptions to nonresident taxpayers while it offers those same exemptions to resident taxpayers.[24] However, the Supreme Court's opinion again states that "if there be no reasonable ground for the diversity of treatment, it abridges the privileges and immunities to which such citizens are entitled."[25]

In the 1975 case *Austin v. New Hampshire*, the Supreme Court examined the New Hampshire Commuters Income Tax under the Privileges & Immunities Clause.[26] The New Hampshire Commuters Income Tax was enacted by the state of New Hampshire to tax nonresident income in excess of $2,000 earned within New Hampshire's boundaries.[27] The Supreme Court held

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[21] 252 U.S. at 55, 58-59.

[22] *Id.* at 57.

[23] *Id.* at 50 (emphasis added). The *Shaffer* Court used the language of reasonableness in its analysis to determine that the state of Oklahoma possessed the power to deny certain business losses. *Id.*

[24] 252 U.S. at 80-81.

[25] *Id.* at 231. The use of the reasonableness standard in both *Shaffer* and *Travis* shows that the substantial reasons standard—leaned on heavily in later rulings like *Lunding* and other cases—was not necessarily relied upon in these earlier tax discrimination rulings. *See id.*

[26] 420 U.S. 656 (1975). At the beginning of the Supreme Court's majority opinion, the complexities of how the New Hampshire Commuters Income Tax operates were explained: "The Commuters Income Tax initially imposes a tax of 4% as well on the income earned by New Hampshire residents outside the State. It then exempts such income from the tax, however: (1) if it is taxed by the State from which it is derived; (2) if it is exempted from taxation by the State from which it is derived; or (3) if the State from which it is derived does not tax such income. The effect of these imposition and exemption features is that no resident of New Hampshire is taxed on his out-of-state income . . . . In effect, then, the State taxes only the incomes of nonresidents working in New Hampshire." *Id.* at 658-59.

[27] *Id.* at 657-58.

that the tax violated the Privileges & Immunities Clause because it fell "exclusively on the income of nonresidents," and there was no offset by taxes imposed on residents.[28] The New Hampshire Commuters Income Tax violated the Privileges & Immunities Clause because the tax failed the Clause's test for "substantial equality of treatment for the citizens of the taxing State and nonresident taxpayers."[29] In *Supreme Court of New Hampshire v. Piper*, the Court clearly laid out the full test for violations of the Privileges & Immunities Clause.[30] *Piper* stated that a tax may pass the test when "(i) there is a substantial reason for the difference in treatment; and (ii) the discrimination practiced against nonresidents bears a substantial relationship to the State's objective."[31]

B. Lunding *and the Categorical Denial of Personal Expense Deductions*

Lunding v. New York showed the Supreme Court's rejection of the state of New York's categorical denial of alimony payments as a discriminatory practice which violated the Privileges & Immunities Clause.[32] As in the *Austin* and *Piper* cases, the Court in *Lunding* focused on analyzing this practice using the "substantial equality of treatment" standard.[33] In its holding, the Supreme Court displayed its view that a fairer method of taxation for nonresidents would feature a pro rata deduction for personal expense deductions.[34] In other words, a personal expense deduction such as alimony, which is generally an amount related to a person's income, should be allocated to a person's nonresident tax return on the basis of the amount of nonresident income the individual earned from that state.[35]

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[28] *Id.* at 665-66.
[29] *Id.* at 665.
[30] 470 U.S. 274, 284 (1985).
[31] *Id.*
[32] Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287, 314-15 (1998).
[33] *Id.* at 297.
[34] *Id.* at 292-93, 305, 314-15.
[35] *Id.* at 314.

1. Justice Ginsburg's Dissent in *Lunding*

In her dissenting opinion, Justice Ginsburg expressed her view that the personal expense deduction exists more as "a method of designating the proper taxpayer for a given amount of income, rather than a tax allowance for particular expenditures."[36] Justice Ginsburg also points to the Supreme Court's ruling in *Travelers' Ins. Co. v. Connecticut* to show how the court upheld a "facially discriminatory" tax as nondiscriminatory under the Privileges & Immunities Clause because of the justification that the nonresidents did not have to pay municipal taxes.[37] Justice Ginsburg points to this aspect of *Travelers'* because this argument uses the exact same justification made by the State of New York in *Lunding*, with the major difference being the Supreme Court's acceptance of the argument in the former case and rejection of it in the latter.[38] Justice Ginsburg then discusses how "historically" the Supreme Court's opinions have not followed a "pattern" and therefore have not set a precedent for completely disallowing a state's categorical denial of personal expense deductions.[39] Justice Ginsburg cites *Comparative Income Taxation: A Structural Analysis* to further her argument: "Historically, both alimony and child support were treated as personal expenses nondeductible [by the payer] and not includable [in the recipient's income]. Successive [federal] statutory enactments beginning in 1942 allowed a deduction and corresponding inclusion for alimony payments while continuing the nondeductible-excludable treatment for child support payments."[40]

2. Two Earlier Rulings: *Shaffer* and *Travis*

Additionally, Justice Ginsburg cited two earlier rulings in which the Supreme Court upheld states' limits on business

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[36] *Id.* at 316-317 (Ginsburg, J., dissenting) (quoting B. BITTKER & M. MCMAHON, FED. INCOME TAXATION OF INDIVIDUALS ¶ 36.7, at 36–18 (2d. ed. 1995).

[37] *Id.* at 318 (citing Travelers' Ins. Co. v. Connecticut, 185 U.S. 364, 371 (1902)).

[38] *Id.* at 319-320.

[39] *Id.* at 320.

[40] *Id.* at 320-21 (quoting HUGH J. AULT, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 277 (1997) (alteration in original)).

deductions and non-business deductions for nonresidents.[41] As a result of the rulings in *Shaffer v. Carter* and *Travis v. Yale & Towne Mfg. Co.*, the Supreme Court "established . . . three principles."[42] First, the Supreme Court found that a state possesses the right to tax incomes being produced from property or businesses from within their state.[43] Additionally, the Supreme Court held that a state cannot deny personal exemptions to nonresidents only when that state uniformly offers those same exemptions to residents.[44] Lastly, the Court clearly ruled that states are not required to provide nonresidents the exact same deductions afforded to residents.[45]

While neither *Shaffer* nor *Travis* specifically upheld the method of nonresident taxation featured in *Lunding*, the application of these cases in lower courts displays a method of nonresident taxation featuring a denial of personal and business deductions to nonresidents.[46] Additionally, Justice Pitney's majority opinion in *Shaffer* emphasized an important power of the states when it recognized the following:

> That a state, consistently with the Federal constitution, may not prohibit the citizens of other states from carrying on legitimate business within its borders like its own citizens of course is granted; but it does not follow that the business of nonresidents may not be required to make a ratable contribution in taxes for the support of the government.[47]

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[41] *Id.* at 323.

[42] *Id.* at 321 (citing Shaffer v. Carter, 252 U.S. 37 (1920); Travis v. Yale & Towne Mfg. Co. 252 U.S. 60 (1920).

[43] *Id.*

[44] *Id.* at 322.

[45] *Id.* "[T]here is no unconstitutional discrimination against citizens of other States in confining the deduction of expenses, losses, etc., in the case of non-resident taxpayers, to such as are connected with income arising from sources within the taxing State. . . ." *Id.* (quoting *Travis* 252 U.S. at 75-76). The language used by Justice Ginsburg in analyzing New York's taxation method in *Lunding* pointed back to the reasonableness standards used within *Shaffer* and *Travis*. *See Lunding*, 522 U.S. at 323-324.

[46] *Id.* at 323-25.

[47] *Shaffer*, 252 U.S. at 52-53.

These rulings show how the Supreme Court historically has favored more of a balance between the rights of nonresident taxpayers and the rights of states' in their taxation of nonresidents.[48] Furthermore, the rulings in *Shaffer* and *Travis* show that the Supreme Court previously gave states wider latitude in determining their own methods of taxation than the Supreme Court allowed in *Lunding*.[49]

C. Maryland's Special Nonresident Tax

1. *Frey v. Comptroller of the Treasury*

In 2011, the Court of Appeals of Maryland ruled on the case of *Frey v. Comptroller of the Treasury*.[50] The Court of Appeals heard the case after an appeal from the Court of Special Appeals of Maryland.[51] A special nonresident tax passed by the state of Maryland taxed nonresidents on income derived from within the state of Maryland.[52] The Comptroller assessed partners of a law firm that operated and derived income from Maryland with the special nonresident tax.[53] The Court of Appeals affirmed the ruling of the Court of Special Appeals and held that the special nonresident tax did not violate the Privileges & Immunities Clause.[54] The court reasoned that the tax did not violate the Privileges & Immunities Clause because Maryland's special nonresident tax did not tax nonresidents more than residents.[55] Additionally, the court agreed with the comptroller that the use of the special nonresident tax was "wholly different" than any tax scheme that the Supreme Court has analyzed with the Privileges & Immunities Clause.[56] On March 26, 2012, the United States Supreme Court denied a petition for writ of certiorari.[57]

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[48] *See id.* at 53.

[49] *See id.*

[50] Frey v. Comptroller of the Treasury, 29 A.3d 475 (Md. 2011).

[51] Frey v. Comptroller of the Treasury, 965 A.2d 923 (Md. App. 2009).

[52] *Frey*, 29 A.3d at 484.

[53] *Id.*

[54] *Id.* at 509.

[55] *Id.*

[56] *Id.* Given the differences in the *Frey* court's analysis from that in *Lunding*, the "wholly different" language used here suggests that the current analysis used in tax

2. A Rebuttal to Chief Justice Bell's Dissenting Opinion

In his dissenting opinion, Chief Justice Bell argued that the "State income tax is 'separate and apart from . . . [the] county income tax.'"[58] Additionally, Chief Justice Bell argued that the burden placed on nonresidents fails to justify the State's Special Nonresident Tax.[59] His last point focused on the belief that the tax lacks validity as a compensatory tax and fails to survive scrutiny under the Commerce Clause.[60]

As referred to in the majority opinion, the Supreme Court previously addressed the issue of state laws that are facially discriminatory.[61] In *Fulton Corporation v. Janice H. Faulkner*, the Supreme Court laid out how a facially discriminatory state tax may pass scrutiny under the Commerce Clause by being a "'compensatory tax' designed simply to make interstate commerce bear a burden already borne by intrastate commerce."[62] Three conditions must be met for a tax to be a compensatory tax and thus survive Commerce Clause scrutiny.[63] First, the burden that the state is compensating for must be known.[64] Second, the compensating amount must be shown to be approximately the amount of the burden for which the state is compensating.[65] Lastly, the interstate and intrastate activities on which the taxes are levied must be "substantially equivalent."[66]

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discrimination cases is not broad enough to apply to all cases of tax discrimination. *Id.* This suggestion at least helps explain some of the inconsistencies that have plagued tax discrimination rulings in the past. This lends credence to the idea that a new, broader analysis could be more beneficial in cases of tax discrimination. *See id.*

[57] Frey v. Comptroller of the Treasury, 132 S. Ct. 1796 (2012) (mem.) (*denying cert. to Frey*, 29 A.3d 475).

[58] *Frey*, 29 A.3d at 523 (Bell, C.J., dissenting) (quoting Comptroller of the Treasury v. Blanton, 390 Md. 528, 541 (2006) (alterations in original)).

[59] *Id.* at 532.

[60] *Id.* at 533.

[61] *Id.* at 485 (majority opinion).

[62] Fulton Corp. v. Faulkner, 516 U.S. 325, 331 (1996) (quoting Assoc. Indus. of Mo. v. Lohman, 511 U.S. 641, 647 (1994)).

[63] *Id.* at 332.

[64] *Id.*

[65] *Id.* at 332-333.

[66] *Id.* at 333. (quoting Armco Inc. v. Hardesty, 467 U.S. 638, 643 (1984)).

In *Frey*, the Tax Court analyzed the Special Nonresident Tax using the aforementioned test and determined that it passed scrutiny under the Commerce Clause as a compensatory tax.[67] Both the Circuit Court for Anne Arundel County and the Court of Special Appeals affirmed the Tax Court's ruling, and the Court of Special Appeals rejected the petitioners' arguments that the Special Nonresident Tax also violated the Equal Protection Act and Privileges & Immunities Clause.[68] The Maryland Court of Appeals affirmed this ruling and remanded the case to the Tax Court to determine whether the abatement of interest was necessary.[69]

Chief Justice Bell's dissent predominantly rests upon his argument that the burden on the state did not justify the Special Nonresident Tax and therefore it was not a valid compensatory tax.[70] However, Chief Justice Bell failed to put forth a substantial reason why the Special Nonresident Tax fails the three-prong test and did very little to discredit the assertions upon which the majority rested their arguments.[71] While Chief Justice Bell argues that the Special Nonresident Tax fails the three-prong test because it is actually a tax separate from the state tax, he fails to produce an argument for why this would completely defeat the Special Nonresident Tax as a valid compensatory tax.[72]

D. Ohio Ad Valorem Taxes and Nonresidents

The case *Allied Stores of Ohio v. Bowers* focused on the state of Ohio's ad valorem tax.[73] The Ohio statute that established the tax in order to tax personal property used in business or stored for use in business exempted nonresidents that merely stored their

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[67] *Frey*, 29 A.3d at 485-86.

[68] *Id.* at 486-88.

[69] *Id.* at 520.

[70] *Id.* at 533 (Bell, C.J., dissenting).

[71] *Id.* at 533.

[72] *Id.* at 531-32.

[73] Allied Stores of Ohio v. Bowers, 358 U.S. 522, 523 (1959). This case illustrates another instance in which the Supreme Court found that no violations had occurred in the taxation of nonresidents. The opinion again displays the Court's approach lending states a "wide discretion" in levying taxes on nonresidents. *See Allied Stores, 358 U.S. at 526.*

property in the state of Ohio.[74] The appellant, an Ohio corporation, brought a suit against the Tax Commissioner of Ohio on the grounds that it violated the Equal Protection Clause of the Constitution of the United States of America.[75] The Supreme Court examined the question of whether the resident, through the ad valorem tax, was denied equal protection under the Fourteenth Amendment.[76] The Court held that the tax did not violate the Fourteenth Amendment[77] and stated that "[t]he States have a very wide discretion in the laying of their taxes."[78]

II. REFRAMING THE APPROACH TO TAX DISCRIMINATION

A. The Supreme Court's Approach to Tax Discrimination

As seen in *Lunding*, the Supreme Court attempts to balance "local needs" and give states discretion pertaining to their methods of taxation.[79] Additionally, the Court tries to avoid focusing on the "form, construction, or definition" and instead focus on the tax's operation and resulting effect.[80] In cases brought to the Court under a cause for violating the Privileges & Immunities Clause, the court uses a two-step substantial reason test.[81]

1. The Use of the Privileges & Immunities Clause and the Two-Step Test

As can be seen in *Lunding*, the Supreme Court uses the Privileges & Immunities Clause with regard to tax discrimination to ensure that nonresidents are placed "upon the same footing with citizens of other States, so far as the advantages resulting from citizenship in those States are concerned."[82]

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[74] *Id.* at 524.

[75] *Id.* at 523-24.

[76] *Id.* at 526.

[77] *Id.* at 530.

[78] *Id.* at 526.

[79] Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287, 297 (1998) (quoting Madden v. Kentucky, 309 U.S. 83, 88 (1940)).

[80] *Id.* (quoting Shaffer v. Carter, 252, U.S. 37, 52-53 (1920)).

[81] *Id.* at 298.

[82] *Id.* at 296 (quoting Paul v. Virginia, 8 Wall. 168, 180 (1868)).

In *Piper*, the Supreme Court laid out the test for violations of the Privileges & Immunities Clause:

> Thus, when confronted with a challenge under the Privileges and Immunities Clause to a law distinguishing between residents and nonresidents, a State may defend its position by demonstrating that "(i) there is a substantial reason for the difference in treatment; and (ii) the discrimination practiced against nonresidents bears a substantial relationship to the State's objective."[83]

As it pertains to tax discrimination, the Supreme Court wants to ensure that "the nonresident [is] not treated more onerously than the resident."[84]

2. *Fulton* and the Commerce Clause

In *Fulton Corporation v. Faulkner*, the Supreme Court laid out how a facially discriminatory state tax may pass scrutiny under the Commerce Clause by being a "'compensatory tax' designed simply to make interstate commerce bear a burden already borne by intrastate commerce."[85] Three conditions must be met for a tax to be a compensatory tax and thus survive Commerce Clause scrutiny.[86] First, the burden that the state is compensating for must be known.[87] Second, the compensating amount must be shown to be approximately the amount of the burden for which the state is compensating.[88] Lastly, the interstate and intrastate activities on which the taxes are levied must be "substantially equivalent."[89]

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[83] *Id.* at 298 (quoting Supreme Court of N. H. v. Piper, 470 U.S. 274, 284 (1985)).

[84] *Id.* at 299 (quoting Austin v. New Hampshire, 420 U.S. 656, 664 (1975)).

[85] Fulton Corp. v. Faulkner, 516 U.S. 325, 331 (1996) (quoting Associated Indus. of Mo. v. Lohman, 511 U.S. 641, 647 (1994)).

[86] *Id.* at 332.

[87] *Id.*

[88] *Id.* at 332-333.

[89] *Id.* at 333 (quoting Armco Inc. v. Hardesty, 467 U.S. 638, 643 (1984)).

3. *Bowers* and the Equal Protection Clause

As the majority discussed in *Allied Stores of Ohio v. Bowers*, states' methods of taxation are subject to the limits placed on them by the Equal Protection Clause of the Fourteenth Amendment.[90] However, the court also stated that the Equal Protection Clause "imposes no iron rule of equality, prohibiting the flexibility and variety that are appropriate to reasonable schemes of state taxation."[91] Additionally, the Supreme Court mentions that states have "sovereign powers in devising their fiscal systems to ensure revenue and foster their local interests."[92] The Supreme Court specifically mentions these ideas of reasonableness and sovereign power with regard to states' methods of taxation because the Court wants to ensure that states are able to generate income in the manner they see fit that suits current needs.[93]

4. Historical Precedent Set by *Shaffer* and *Travis*

The clearest precedent set out by the Supreme Court can be found in the rulings in *Shaffer* and *Travis*.[94] The majority opinion in *Shaffer* set the following precedent:

> In our system of government the states have general dominion, and, saving as restricted by particular provisions of the federal Constitution, complete dominion over all persons, property, and business transaction within their borders; they assume and perform the duty of preserving and protecting all such persons, property, and business, and in consequence, have the power normally pertaining to governments to resort to all reasonable forms of taxation in order to defray the governmental expenses.[95]

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[90] Allied Stores of Ohio v. Bowers, 352 U.S. 522, 526 (1959).

[91] *Id.*

[92] *Id.*

[93] *Id.*

[94] Shaffer v. Carter, 252 U.S. 37 (1920); Travis v. Yale & Towne Mfg. Co. 252 U.S. 60 (1920).

[95] Shaffer v. Carter, 252 U.S. 37, 50-51 (1920).

Through *Shaffer*, the Supreme Court sought to convey that the Constitution places specific restrictions on states' methods of taxation but should not dictate states' means of defraying governmental expenditures.[96] Therefore, a reasonable justification must be shown by the state in order for a facially discriminatory law to pass the Supreme Court's scrutiny.[97]

In *Travis*, the Supreme Court specifically mentions a state's need of a "reasonable ground" for a difference in taxation treatment.[98] Only if there is an absence of reasonable grounds for disparate treatment does a state's method of taxation curtail "the privileges and immunities to which citizens are entitled."[99] These references point to the Supreme Court's intention to apply a reasonableness standard in determining whether a state's method of taxation violates a provision of the Constitution.[100]

B. Maryland's Approach

1. Commerce Clause

In *Frey*, the Maryland Court of Appeals analyzed Maryland's Special Nonresident Tax using the Commerce Clause, the Equal Protection Clause, and the Privileges & Immunities Clause.[101] When discussing the Commerce Clause, the court laid out the principles the Supreme Court of the United States laid out in *Shaffer*, such as its use of the compensatory tax doctrine.[102] Leaning on the Supreme Court's ruling in *Shaffer*, the court stated, "As long as the burden the state imposes on nonresidents is not more onerous in effect than that imposed on residents, such a tax remains a legitimate exercise of state power."[103] Furthermore, the court discussed how nonresidents' usage of other states to generate income costs both indirect and direct expenses,

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[96] *See id.*
[97] *See id.*
[98] *Travis*, 252 U.S. at 79.
[99] *See id.*
[100] *See id.*
[101] Frey v. Comptroller of Treasury, 29 A.3d 475 (Md. 2011).
[102] *Id.* at 495.
[103] *Id.* at 497 (citing Shaffer v. Carter, 252 U.S. 37, 50 (1920)).

such as police, sewer services, roads, and other local activities.[104] Since Maryland's Special Nonresident Tax compensates the state for these services, the tax passed the first prong for the compensatory tax test under the Commerce Clause.[105]

The court also had to examine whether the tax compensates for a "legitimate intrastate tax burden."[106] The Comptroller identified the county tax as the tax burden for which the state was being compensated, and the court accepted this logic because the county tax and state tax form a complementary tax system with both taxes being due to the state.[107] Additionally, the court found that the tax passed the second prong of the compensatory test because the "triggering events" that give rise to the tax are "sufficiently similar in substance."[108] Finally, the court completed its analysis under the dormant Commerce Clause by determining that the Special Nonresident Tax "ensures that all individuals competing in Maryland's marketplace compete on equal footing" by levying a tax on those who generate income in Maryland but avoid paying the county income tax.[109]

2. Equal Protection Clause

In *Frey*, the court then began its analysis of the Special Nonresident Tax using the Equal Protection Clause of the Fourteenth Amendment of the United States Constitution.[110] The court laid out the proper analysis for the Equal Protection Clause by quoting precedent set by the Supreme Court which states that "[i]f the classification is not purely arbitrary and has a rational basis, the statute does not violate the Equal Protection Clause."[111] The *Frey* court found that a rational basis for the Special Nonresident Tax existed because it levied taxes on those who

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[104] *See id.* at 498.

[105] *Id.*

[106] *See id.*

[107] *See id.*

[108] *Id.* at 503 (citing Fulton Corp. v. Faulkner, 516 U.S. 325, 333 (1996) (quoting Or. Waste Sys., Inc., v. Dep't of Envtl. Quality of Or., 511 U.S. 93, 103 (1994)).

[109] *Id.* at 505.

[110] *Id.*

[111] *Id.* (citing Governor of Maryland. v. Exxon Corp., 279 Md. 410, 439 (1977)).

avoid paying the county income tax.[112] The court showed its reasoning with the following language:

> [N]onresidents are taxed, not because they are nonresidents earning income in Maryland, but because the tax scheme through which the state funds local services imposes taxes according to the county in which the taxpayer is domiciled and nonresidents will otherwise fall outside of the scope of that scheme.[113]

In this way, the court held the Special Nonresident Tax to be a part of the greater tax scheme of the state as a whole, and therefore a rational basis existed for levying this tax on those who were previously avoiding the payment of a county income tax.[114]

3. Privileges & Immunities Clause

The last part of the court's analysis in *Frey* examined the Special Nonresident Tax in light of the restrictions placed on states by the Privileges & Immunities Clause.[115] The court cited *Lunding* for the test under the Privileges & Immunities Clause:

> Thus, when confronted with a challenge under the Privileges and Immunities Clause to a law distinguishing between residents and nonresidents, a State may defend its position by demonstrating that (i) there is a substantial reason for the difference in treatment; and (ii) the discrimination practiced against nonresidents bears a substantial relationship to the State's objective.[116]

Using this analysis, the court in *Frey* first addressed whether a substantial reason existed for a difference in treatment of residents and nonresidents.[117] The court found that seeking

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[112] *Id.* at 508.
[113] *Id.*
[114] *Id.*
[115] *Id.* at 508-09.
[116] *Id.* (citing Lunding v. New York Tax Appeals Tribunal, 522 U.S. 287, 297 (1998)).
[117] *See id.* at 510.

compensation for local government services used by nonresidents satisfied the substantial reason test.[118]

In deciding whether the discrimination possessed a substantial relationship to the objective of the state, the court found that the Special Nonresident Tax was "tailored to serve the State's particular purpose" of obtaining funding for local governments.[119] Also, the tax was "imposed solely on income earned in Maryland and thus is tied to the nonresident's relationship with the State."[120] Additionally, the court ended its analysis of the tax in light of the Privileges & Immunities Clause by noting that "[p]erfect equality" is not obligatory, and the tax scheme enacted by Maryland did not result in a higher income tax being paid by nonresidents.[121] Therefore, the court found that the Special Nonresident Tax passed both tests of the Privileges & Immunities Clause.[122]

C. A New Approach: Allow States to Maintain Autonomy by Shifting Focus to Substantial Equality in the Tax Burden Placed and Requiring a Rational Relationship Test

In *Lunding*, the court felt that the denial of a nonresident's alimony deduction violated their rights under the Privileges & Immunities Clause.[123] However, the Supreme Court previously held that a nonresident's rights are not violated if there is a reasonable distribution of burdens where no deliberate discrimination is present.[124] Additionally, as seen in *Shaffer*, the Supreme Court allowed Oklahoma to deny business deductions to nonresidents that were not incurred within the state.[125]

In light of Maryland's approach to taxing nonresidents and the analysis used by the Supreme Court with the Privileges &

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[118] *Id.*

[119] *Id.* at 511.

[120] *Id.*

[121] *Id.* (quoting Traveller's Ins. Co. v. Connecticut, 185 U.S. 364, 372 (1902)).

[122] *Id.*

[123] *See* Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287, 315 (1998).

[124] *Id.* at 318 (Ginsburg, J., dissenting) (quoting Traveller's Ins. Co. v. Connecticut, 185 U.S. 364, 371 (1902)).

[125] *Id.* at 322 (Ginsburg, J., dissenting) (citing Shaffer v. Carter, 252 U.S. 37, 57 (1920)).

Immunities Clause, several fundamental questions about states' taxation powers arise.[126] For instance, with the blurry lines accompanying the substantial reasons test, the difficulty in determining the Supreme Court's role and influence in a state's methods of taxation remained "murky."[127] This confusion has led to many diverging opinions about how a state's method of taxation should correlate with nonresident's income-producing activities in that state.[128] One suggestion that has been proposed is to allow nonresidents to take a "pro rata deduction for personal expenses such as alimony."[129] However, this solution offers no help in terms of clearing up the Supreme Court's role in cases of tax discrimination with regard to past precedents set in *Shaffer* and *Travis*.[130]

If the differing analyses of the Privileges & Immunities Clause, Commerce Clause, and Equal Protection Clause were to be reconciled, a more effective approach to cases of tax discrimination would carve out the Supreme Court's role in protecting nonresidents while still allowing states to have autonomy in their methods of taxation.[131] If the Supreme Court shifted its focus in its opinions on tax discrimination to ensuring that nonresidents are placed "upon the same footing with citizens of other States" as well as ensuring that the existence of any unequal treatment bears a rational relationship to the state's objective, a much simpler analysis for cases of tax discrimination would result.[132] To avoid the tediousness of the substantial

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[126] *See* Frey v. Comptroller of Treasury, 29 A.3d 475 (Md. 2011); *see also* John Bourdeau, J.D., et al, *Privileges and Immunities of Citizenship*, 71 AM. JUR. 2D STATE AND LOCAL TAXATION §73 (2013).

[127] *See* David Schmudde, *Constitutional Limitations on State Taxation of Nonresident Citizens*, 1999 L. REV. MICH. ST. U. DET. C. L. 95, 167 (1999).

[128] *See* James Michael Daily, *The Thin Line Between Acceptable Disparate Tax Treatment of Nonresidents and Unconstitutional Discrimination Under the Article IV Privileges and Immunities Clause: Lunding v. New York Tax Appeals Tribunal, 118 S. Ct. 766 (1998)*, 21 HAMLINE L. REV. 563, 615 (1998).

[129] *Id.*

[130] *See id. See also* Frey v. Comptroller of the Treasury, 29 A.3d 475 (Md. 2011).

[131] *See id. See also Frey*, 29 A.3d at 492-511; Lunding v. New York Tax Appeals Tribunal, 522 U.S. 287 (1998); Shaffer v. Carter, et al., 252 U.S. 37 (1920); Travis v. Yale & Towne Mfg. Co. 252 U.S. 60 (1920).

[132] *Lunding*, 522 U.S. at 296 (quoting Paul v. Virginia, 8 Wall. 168, 180 (1868)).

reasons test and compensatory tax analysis, the Supreme Court should solely focus on the resulting burden placed upon nonresidents and the reasoning behind a state tax on a rational level to examine whether a nonresident's rights have been curtailed.[133] This method of analyzing tax discrimination cases would allow states to have the appropriate amount of autonomy in determining their methods of taxation, as seen in *Shaffer* and *Frey*.[134]

1. First Prong – Substantial Equality in the Tax Burden Placed

As seen in *Frey*, an analysis that is attempting to measure substantial equality becomes much simpler when the focus is primarily placed on the amount of income tax similar individuals are paying.[135] The Supreme Court referenced this thought in their analysis of a Louisiana use tax in *Halliburton v. Oil Well Cementing Company v. James S. Reily, Collector of Revenue, State of Louisiana*.[136] In *Halliburton*, the Supreme Court stated that an inequality in Louisiana's taxation of residents and nonresidents appeared to be merely "an accident of statutory drafting"[137] but that, most importantly, "equality for the purposes of competition and the flow of commerce is measured in dollars and cents, not legal abstractions."[138] By focusing primarily on comparing the income tax levied upon resident and nonresident taxpayers, the benefits of practicality and simplicity become evident, especially when analyzing cases such as *Frey* and *Lunding*.[139] This approach would ensure that states' taxation of residents and nonresidents, no matter the method chosen, remained substantially equal using a quantifiably comparable measurement.

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[133] *See* Daily, *supra* note 128.

[134] *See Shaffer*, 252 U.S. 37 at 50-51; *See also Frey*, 29 A.3d at 492-511.

[135] *See Frey*, 29 A.3d at 508.

[136] Halliburton Oil Well Cementing Co. v. James S. Reily, Collector of Revenue, State of Louisiana, 373 U.S. 64, 70 (1963).

[137] *Id.* at 72.

[138] *Id.* at 70.

[139] *See Frey*, 29 A.3d at 492-513; *See also* Lunding v. New York Tax Appeals Tribunal, 522 U.S. 287 (1998).

2. Second Prong – A Rational Relationship Test

As previously discussed, *Shaffer* and *Travis* both showed the Supreme Court's intent to examine tax discrimination using a standard of reasonableness.[140] Additionally, the holdings in *Lunding* and *Frey* display the inherent complexity and subjectivity in determining whether a tax is appropriately compensatory or whether a state's reasoning substantially relates to the method of taxation.[141] To restore the Supreme Court's original approach to tax discrimination and simplify the approach the Supreme Court now uses, the second prong of the new approach would require states to produce evidence that the tax being levied bears a rational relationship to the State's objective. Coupled with the first prong's focus on the equality of the tax burden, a rational relationship test would ensure that a state cannot tax a group of people such as nonresidents without a reasonable basis for doing so. A rational relationship test would also still allow a state to have autonomy in its methods of taxation to defray the increasing costs of government expenditures.

III. APPLYING THE NEW APPROACH

A. Lunding *under the New Approach*

If the Supreme Court had applied the new approach in *Lunding*, a major difference would have been the simplicity and straight-forwardness of the Supreme Court's analysis and holding.[142] As mentioned previously, the test for violations of the Privileges & Immunities Clause entail seeing if there is a substantial reason for a difference in treatment and whether the discrimination substantially relates to the objective of the State.[143] Instead of having to analyze the case with the tedious substantial

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[140] Shaffer v. Carter, et al., 252 U.S. 37 (1920); Travis v. Yale & Towne Mfg. Co. 252 U.S. 60 (1920).

[141] *See Frey*, 29 A.3d at 492-513; *See also Lunding*, 522 U.S. 287 (1998).

[142] *See generally Lunding*, 522 U.S. 287 (1998).

[143] *Id.* at 298

reasons test, the Court could have used the new approach to address the crux of the issue.[144]

Under the first prong of the new approach, the court would have only needed to compare the burden placed on the nonresident taxpayer and the tax burden placed on a hypothetical resident taxpayer in similar circumstances.[145] With the taxpayer in *Lunding*, the Supreme Court would have focused on the cumulative effect that eliminating the nonresident taxpayer's alimony deduction would have on the nonresident's tax liability.[146] The Court then would have compared that taxpayer's burden to a hypothetical resident taxpayer with the same income amount. However, included in the resident taxpayer's burden would be any taxes paid that could potentially be applicable to nonresidents using the state's arguments, such as municipal taxes paid by the resident but not paid by the nonresident. Therefore, following the Court's analysis in the *Lunding* opinion, the Court would have come to a quick conclusion on whether there was an inequality in the tax burden placed by comparing the tax liability of the nonresident to that of the hypothetical resident taxpayer. If a substantial inequality in the tax burden was found to exist, the tax would then proceed to the second prong of the new approach. If a substantial inequality did not exist, the Court would be enabled to automatically uphold the tax.

Under the second prong of the new approach, the Court would examine whether the tax has a rational relationship to the State's objective. In other words, the State would have to have a reasonable basis for the tax, and the basis would have to be grounded in the defrayment of government expenditures that benefit the nonresidents being taxed. By strengthening the "substantial" language of the first prong with an objective, quantitative test in the hypothetical taxpayer method, a rational level of scrutiny would be appropriate for the second prong of the

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[144] *See generally id.* As referenced previously, the major crux of the issues examined in *Shaffer*, *Travis*, *Lunding*, and *Frey* was whether the nonresident taxpayer's burden outweighed the burden placed upon residents. The use of a hypothetical taxpayer would more clearly and objectively present this information for a quantitative comparison. *See generally id.*

[145] *See generally id.*

[146] *See generally id.*

approach. Therefore, a state would only have to show a rational relationship between the tax and the state's objective once the tax survived the first prong's test by displaying a lack of a substantial inequality in the tax burden placed using the hypothetical taxpayer method.

B. Frey *under the New Approach*

In *Frey*, the court analyzed Maryland's Special Nonresident Tax with the Commerce Clause, the Equal Protection Clause, and the Privileges & Immunities Clause.[147] The court's analysis with the Commerce Clause uses the overly complex compensatory tax doctrine.[148] The compensatory tax doctrine is used to determine whether a facially discriminatory tax on interstate commerce survives strict scrutiny.[149] The compensatory tax doctrine focuses on identifying the tax burden for which the state is attempting to compensate, showing that the interstate commerce tax is roughly equivalent to the intrastate commerce tax, and demonstrating that the events upon which the intrastate and interstate taxes are being imposed are substantially equivalent.[150]

While the new approach would seem to be more applicable to cases that focus the analysis on the Privileges & Immunities Clause, such as *Lunding*[151], the incorporation of the first prong of the new approach would lend clarity and simplicity to the other elements of the compensatory tax doctrine. The idea of comparing a hypothetical resident taxpayer to that of a nonresident could also be applied to the compensatory tax doctrine by comparing a hypothetical person being burdened by an intrastate tax burden with a person being burdened with an interstate tax burden. With the compensatory tax doctrine's focus on the equivalency of the taxes and the events upon which those taxes arise, an objective comparison of dollars and cents could bring clarity to this analysis as opposed to a subjective measurement using qualitative terms. However, since the court in *Frey* found that the Special

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147 *See* Frey v. Comptroller of the Treasury, 29 A.3d 475, 492-513 (Md. 2011).

148 *See id.* at 495.

149 *Id.* at 494.

150 *Id.* at 495.

151 *See generally Lunding*, 522 U.S. 287 (1998).

Nonresident Tax passed the compensatory tax doctrine in its current form, the new approach would not have changed the outcome of the court's analysis using the Commerce Clause.[152]

When the court analyzed the Special Nonresident Tax using the Equal Protection Clause, the court examined it using the criteria laid out by the Supreme Court.[153] The court examined whether the class of persons being taxed "is not purely arbitrary and has a rational basis."[154] As long as these criteria are met, the tax does not constitute a violation of the Equal Protection Clause.[155] Here the new approach would not have much effect, if any, on the current Equal Protection analysis. The standard for Equal Protection issues used in *Frey*[156] already employs a rational examination of the Special Nonresident Tax, and therefore the second prong of the new approach fits within this same standard. Additionally, the new approach's first prong focus on the equality of the tax burden placed would not help the court's examination for a violation of the Equal Protection Clause since equality is not highlighted as one of the focuses for this analysis.[157]

The court's analysis of the tax under the Privileges & Immunities Clause, much like *Lunding*[158], focuses on substantial equality between resident and nonresident taxpayers and a substantial relationship to the State's objective.[159] Because of the State's argument that the Special Nonresident Tax is to compensate for government expenditure that is already collected from resident taxpayers in the form of county and municipal taxes, the court finds that the tax does not violate the Privileges & Immunities Clause.[160] The greatest advantage of the new approach in the court's analysis using the Privileges & Immunities Clause would come in the form of offering a clearer, more efficient manner of arriving at that conclusion. By

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[152] *See Frey*, 29 A.3d at 505.
[153] *Id.*
[154] *Id.* (quoting Governor of Md. v. Exxon Corp., 279 Md. 410, 439 (1977)).
[155] *Id.*
[156] *See Frey*, 29 A.3d at 505.
[157] *Id.*
[158] *See Lunding*, 522 U.S. 287 (1998).
[159] *Frey,* 29 A.3d at 509.
[160] *Id.* at 513.

examining the equality of the tax burden using the first prong of the new approach, the court would be able to clearly display the effects of the tax on nonresidents and whether the tax burdens between residents and nonresidents are in fact substantially equal. When using the second prong of the new approach, the court would be able to accept the rational relationship collecting taxes from nonresidents has to the defrayment of government expenditures in the form of local and county services.

C. The Greater Effect of the New Approach

The analysis used under the new approach would provide for a more streamlined and clearer analysis of tax discrimination cases like *Lunding*[161] and *Frey*[162]. The greater effect of this approach would lend states the autonomy needed in their methods of taxation while also ensuring that taxpayers are still protected by the appropriate level of scrutiny in instances of a controversial tax. The use of a hypothetical resident taxpayer in determining whether a nonresident taxpayer bears an unequal tax burden would serve to add an easily calculable, objective dimension that has been missing from the standard test used when examining a tax for discrimination under the Privileges & Immunities Clause. The inherent subjectivity of the standard test would be minimized by the use of a hypothetical resident taxpayer, and both courts and states would benefit from the resulting clearer line of thinking. An objective measure for determining whether a substantial inequality exists would clarify the differences between a discriminatory tax and a non-discriminatory tax.

Furthermore, this added objectivity would allow for a rational level of scrutiny in cases of tax discrimination, and therefore the reasoning used in the landmark cases of *Shaffer*[163] and *Travis*[164] could once again be employed in the analysis of potentially discriminatory taxes. The area of tax discrimination desperately needs a clearer and more concise approach in order to clarify

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[161] *See generally Lunding*, 522 U.S. 287 (1998).
[162] *See generally Frey* at 492-513.
[163] *See generally* Shaffer v. Carter, 252 U.S. 37 (1920).
[164] *See generally* Travis v. Yale & Towne Mfg. Co. 252 U.S. 60 (1920).

exactly what qualifies as tax discrimination. Additionally, the new approach would serve to clarify the role that courts serve in this determination and more clearly present the methods of taxation states are permitted to use.

CONCLUSION

The line of Supreme Court cases in the area of tax discrimination has resulted in inconsistent rulings and a blurry distinction between those methods of taxation that are acceptable and those that are not. A new approach is needed not only for states and taxpayers but for state courts as well. The new approach should be practical enough to quantifiably show any potential disparate treatment that a tax may create and clear enough that courts may apply standards that result in consistency for rulings in tax discrimination cases. A two-pronged approach which balances practicality and clarity would bring about the necessary structure needed in tax discrimination rulings and help to reduce confusion with regards to past precedents set by the Supreme Court's rulings. By focusing on the substantial equality of the tax burden placed using the hypothetical resident taxpayer method and a tax's rational relationship to a State's objective, cases focused on a potentially discriminatory tax could be ruled upon in a much clearer and more efficient manner. This new approach would enable states to take advantage of the wide latitude in which they historically are entitled to exercise in their methods of taxation.

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