Taxpayers that engage in litigation generally seek to win, but a state tax win is akin to salt in a wound when the decision is applied only prospectively. For example, in Maryland State Comptroller of the Treasury v. Wynne, the Maryland comptroller is seeking to undermine a recent taxpayer victory by attempting to apply the decision prospectively for nonparties. In this installment of A Pinch of SALT, we examine the requirements and ramifications of states’ attempts to apply prospective-only remedies to unconstitutional taxes and why Wynne is not an appropriate case for prospective-only relief.

Wynne-ing the Battle, but Losing the War?

Brian Wynne, a Maryland resident and owner of a 2.4 percent interest in an S corporation operating and paying taxes in 39 states, appealed a Maryland comptroller assessment asserting that he failed to pay a county income tax. Maryland treats income earned by a subchapter S corporation as passed through to its shareholders, and the Maryland and county income taxes reach all income of a Maryland resident. Although Maryland allows a credit against the state income tax for income taxes paid to other states, it does not allow a similar credit against the county tax. The court of appeals concluded that the “failure of the Maryland income tax law to allow a credit against the county tax” violated the U.S. Constitution’s dormant commerce clause because it was not fairly apportioned and it discriminated against interstate commerce. The court reasoned that Maryland’s tax scheme discouraged residents from engaging in income-earning activities in other states and that taxpayers would be taxed at a higher rate on income earned through out-of-state activities than on income earned on in-state activities.

Wynne advocated that the county income tax, the credit, or some part of the Maryland tax scheme should be struck down. However, the court of appeals concluded that the county income tax and credit were not, in and of themselves, unconstitutional — rather, what was unconstitutional was the lack of a credit applied to the county income tax. The court noted that Maryland had repealed a similar credit in 1975 and that it was that amendment that rendered the Maryland scheme unconstitutional. The court then directed the circuit court to recalculate Wynne’s tax liability in a manner consistent with its opinion.

Maryland’s Do-Over

On February 27 the Maryland comptroller filed a motion for reconsideration with the court of appeals. The comptroller is requesting the court to reconsider its decision that the Maryland tax scheme is unconstitutional, or to declare that its
decision will operate only prospectively for nonparties.\textsuperscript{11} The comptroller reasons that the taxation scheme at issue is not facially discriminatory because the “same concerns do not arise when the asserted clash is between one state taxing a resident’s income and another state taxing some or part of that income as a non-resident.”\textsuperscript{12}

In support of prospective application, the comptroller claims that the court of appeals’ ruling would expand the tax credit in a manner that the General Assembly did not intend and that the General Assembly and local governments should have the opportunity to mitigate the effect of implementing a county-level credit.\textsuperscript{13} The comptroller’s main argument for a prospective application, however, is that the cost to the local governments would be too great.\textsuperscript{14}

The comptroller’s position would treat similarly situated taxpayers differently by providing the credit to Wynne for past years but denying other taxpayers retroactive relief.

The comptroller’s position would treat similarly situated taxpayers differently by providing the credit to Wynne for past years but denying other taxpayers retroactive relief. The comptroller’s quest to limit nonparties to prospective-only relief ignores a long line of U.S. Supreme Court cases addressing the appropriate remedy for unconstitutional taxes.

When Remedies Do Not Provide Relief

In \textit{McKesson Corp. v. Division of Alcoholic Beverages & Tobacco},\textsuperscript{15} the U.S. Supreme Court held that prospective-only relief was insufficient when a taxpayer had involuntarily paid a discriminatory tax and was not given a pre-deprivation opportunity to contest the tax before payment.\textsuperscript{16,17} Florida, therefore, was required to provide “meaningful backward-looking relief” to the taxpayer.\textsuperscript{18} The Court determined that Florida could meet the meaningful backward-looking relief requirement by offering refunds to the discriminated class, assessing back taxes on the favored class, or using some combination of the two.\textsuperscript{19}

However, the Supreme Court has acknowledged that prospective-only relief may be permissible in some instances, based on a three-part test developed by the Court in \textit{Chevron Oil Co. v. Huson}:

First, the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed. Second, . . . we must . . . weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation. Finally, we [must] weigh[ ] the inequity imposed by retroactive application, for where a decision of this Court could produce substantial inequitable results if applied retroactively, there is ample basis in our cases for avoiding the injustice or hardship by a holding of nonretroactivity.\textsuperscript{20}

The Court applied this test in a pair of cases involving highway use taxes. In \textit{American Trucking Associations, Inc. v. Scheiner (ATA I)},\textsuperscript{21} the Court held that Pennsylvania’s flat highway use tax was unconstitutional because it discriminated against interstate commerce, and overruled precedents that had previously upheld similar taxes. The Arkansas Supreme Court thereafter held that Arkansas’s similar tax was unconstitutional in light of \textit{ATA I} but refused to refund taxes placed in escrow after the decision in \textit{ATA I}.\textsuperscript{22} In \textit{American Trucking Associations, Inc. v. Smith (ATA II)},\textsuperscript{23} the Court held that \textit{ATA I} should be applied prospectively but that the \textit{ATA II} taxpayers were entitled to refunds for the post-ATA I escrowed amounts.

The decision in \textit{ATA II} to provide prospective relief was not without controversy; the dissent argued that the decision should be remanded to the Arkansas Supreme Court to determine the meaningful backward-looking relief to which the taxpayers were entitled under \textit{McKesson}.\textsuperscript{24} Justice Antonin Scalia ultimately cast the deciding vote in \textit{ATA II}.\textsuperscript{25} While expressing sympathy for the dissent’s position “that prospective decisionmaking is incompatible

\begin{itemize}
  \item \textsuperscript{11}Id.
  \item \textsuperscript{12}Id. at 5. Emphasis in original.
  \item \textsuperscript{13}Id. at 10.
  \item \textsuperscript{14}Id. at 9-11.
  \item \textsuperscript{15}496 U.S. 18 (1990).
  \item \textsuperscript{16}Id. at 36-37.
  \item \textsuperscript{17}Even when a taxpayer is provided with a pre-deprivation remedy to challenge the tax before payment, the taxpayer may not be entitled to retain the withheld payments if the jurisdiction opts to remedy the discrimination by imposing the tax on the favored class rather than by granting a refund. \textit{See, e.g.}, Hellerstein and Hellerstein, para. 4.17[1][b].
  \item \textsuperscript{18}Id. at 39.
  \item \textsuperscript{19}Id. at 40-41.
  \item \textsuperscript{20}\textit{Chevron Oil Co. v. Huson}, 404 U.S. 97 (1971).
  \item \textsuperscript{21}483 U.S. 266 (1987).
  \item \textsuperscript{22}\textit{American Trucking Ass'ns, Inc. v. Gray}, 746 S.W.2d 377 (Ark. 1988).
  \item \textsuperscript{23}496 U.S. 167 (1990).
  \item \textsuperscript{24}Id. at 225 (Stevens, J., dissenting).
  \item \textsuperscript{25}Id. at 200 (Scalia, J., concurring).
\end{itemize}
with the judicial role, which is to say what the law is, not to prescribe what it shall be,” he ultimately felt compelled to join the plurality based on his “disagreement with [the] Court’s ‘negative’ Commerce Clause jurisprudence.”26

Although prospective application may be permitted in some cases, in James B. Beam Distilling Co. v. Georgia,27 the U.S. Supreme Court ruled that “selective prospectivity” is not permissible. The question in James B. Beam was how to apply a decision that a Georgia liquor excise tax violated the commerce clause.28 The Georgia Supreme Court had based its determination that prospective application was appropriate on a U.S. Supreme Court decision that a similar tax was unconstitutional in Bacchus Imports, Ltd. v. Dias (Bacchus).29-30 Applying the Chevron test, the state supreme court reasoned that Bacchus had established a new rule and that the balance of the equities weighed in favor of the state because of the “severe financial burden” that retroactive application would create.31 The Supreme Court rejected the state supreme court’s prospective-only treatment because Bacchus itself had been applied retroactively to the taxpayer in that case.32 Justice David Souter stated that “once retroactive application is chosen for any assertedly new rule, it is chosen for all others who might seek its prospective application.”33 The Court thus rejected “selective prospectivity,” in which a new rule announced in a case would be applied to the litigants but the old rule would be applied to all others, stating that “when the Court has applied a rule of law to the litigants in one case it must do so with respect to all others not barred by procedural requirements or res judicata.”34 Further, Justices Harry Blackmun, Thurgood Marshall, and Scalia, while agreeing with Souter’s conclusion, argued that prospectivity, whether “pure” or “selective,” is beyond the Court’s power.35 They reasoned that to apply “principles determined to be wrong to litigants who are in or may still come to court” would violate “the integrity of judicial review.”36

California’s Creative Remedies

Few cases have been deemed to meet the standards set forth in Chevron and ATA II, so courts frequently fashion remedies based on the principles set forth in McKesson. California’s litigation over the constitutionality of its dividends received deduction (DRD) and qualified small business stock provisions offers two examples.37

Historically, California had provided an 80 percent DRD, but only if the dividends were paid from income that was subject to California tax.38 In Farmer Brothers v. Franchise Tax Board,39 the California Court of Appeal determined that the DRD favored dividend-paying corporations doing business in California and paying California taxes over dividend-paying corporations that did not do business in California and paid no taxes in California.40 Thus, the deduction was “facially discriminatory under the commerce clause” because it discriminated between transactions on the basis of an interstate element.41

Applying the options set forth in McKesson, the Franchise Tax Board opted to bifurcate the remedy into a combination of refunds and assessments.42 For periods closed by the statute of limitations, and for which the FTB could not assess additional taxes via the denial of a DRD, the FTB provided refunds.43 However, for periods open under the statute of limitations, the FTB opted to deny the DRD for all taxpayers and issued assessments.44

The FTB’s decision to eliminate the DRD for periods open under the statute of limitations was challenged in Abbott Laboratories v. Franchise Tax Board.45 The California Court of Appeal determined that the state’s DRD could not be salvaged by striking the discriminatory component and saving the remaining DRD, and that doing so would be considered “judicial policymaking” that “encroaches on the Legislature’s function and violates the separation of powers doctrine.”46 The court of appeal thus upheld the FTB’s decision to provide “meaningful backward looking relief” by issuing refunds for years when the statute of limitations was closed, and issuing assessments to the favored class for years when the statute of limitations remained open.47

The FTB is seeking to impose a similar remedy in response to the California Court of Appeal’s decision

26Id. at 204-205 (Scalia, J., concurring).
28Id.
31Id.
32James B. Beam, 501 U.S. at 543 (opinion of Souter, J.).
33Id.
34Id. at 544.
35Id. at 548 (opinion of Blackmun, J.); James B. Beam, 501 U.S. at 549 (opinion of Scalia, J.).
36Id. at 547-548 (opinion of Blackmun, J.).
38Calif. Revenue and Taxation Code section 24402.
40Id. at 986-987.
41Id.
43Id.
44Id.
46Id. at 1381.
47Id. at 1360-1362.
in *Cutler v. Franchise Tax Board*,\(^{48}\) in which the court held that California’s statute excluding or deferring gain from the sale or exchange of qualified small business stock (QSBS) was unconstitutional. California’s QSBS provision generally mirrors the federal law; however, the provision also conditioned the exclusion or deferral on the requirement that at least 80 percent of the company’s payroll be within California at the time that the stock was purchased and at least 80 percent of the assets and payroll be within California during the taxpayer’s holding period for the stock.\(^{49}\) The court of appeal held that the 80 percent limitation was unconstitutional.\(^{50}\)

As it did regarding the DRD, the FTB took the position that the QSBS exclusions and deferrals previously allowed under California law were invalid.\(^{51}\) Therefore, taxpayers who took advantage of the QSBS provision in years still open for assessment under the statute of limitations must recompute their taxable income for each open year without excluding or deferring gains from the dispositions of QSBS.\(^{52}\) Typically, those taxpayers will owe additional tax and interest but will not be subject to penalties.\(^{53}\) The QSBS exclusion or deferral will be permitted for tax years closed by the statute of limitations for all taxpayers that meet the QSBS requirements other than the 80 percent requirements, entitling taxpayers that have filed timely claims to refunds.\(^{54}\) Notably, to avoid impending assessments for years open under the statute of limitations, the California State Legislature is considering legislation that would retroactively enact similar incentives that do not discriminate against interstate commerce.\(^{55}\)

**Conclusion**

State and local governments have a wide range of options when determining a remedy for an unconstitutional tax. Most commonly, those involve a combination of refunds to and assessments on the favored class. That combination is arguably less than fair to taxpayers who have spent years and hundreds of thousands of dollars on litigation, but at least it offers a compromise.

The three-part *Chevron* test sets a high bar to warrant prospective-only application, and the comptroller has made no meaningful attempt to show that it has been met.

In contrast, there is no support for the remedy advocated by the Maryland comptroller in *Wynne*. The three-part *Chevron* test sets a high bar to warrant prospective-only application, and the comptroller has made no meaningful attempt to show that it has been met. Striking down a taxation scheme that taxes interstate commerce more heavily than intrastate commerce does not create a new rule of law or case of first impression, and continuing to deny a credit against the county income tax is inconsistent with established commerce clause principles. The comptroller’s claim that implementing a county credit for past years will cost Maryland money is not a sufficient basis for upholding a discriminatory and unfairly apportioned tax, albeit temporarily. Obviously, that holding would allow jurisdictions to impose unconstitutional taxes without the responsibility (or fear) of having to return them.

Finally, adopting a remedy that provides *Wynne* a credit against its county income tax, but applies the decision prospectively only for similarly harmed taxpayers, cannot be reconciled with the U.S. Supreme Court’s rejection of “selective prospectivity.” *James B. Beam* called for consistent treatment among taxpayers in different states who contested different taxes. The Maryland Court of Appeals should reject the comptroller’s motion for reconsideration.\(^\star\)

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\(^{49}\)Id. at 1251.

\(^{50}\)Id. at 1261.


\(^{52}\)Id.

\(^{53}\)Id.

\(^{54}\)Id.

\(^{55}\)California AB 901, 2013-2014 Reg. sess. (Cal. 2013), introduced by Assembly member Bob Wieckowski (D).