

**STATE AND LOCAL TAX POLICY:
CHALLENGING THE USE OF TAX INCENTIVES**

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Abstract

A recent Sixth Circuit case challenged the validity under the Commerce Clause of the US constitution of an Ohio income tax investment credit. Tax credits and other subsidies offered by the states and local municipalities have been used as part of an economic development strategy, often to recruit or retain business activity within the borders. Some of these subsidies may be subject to challenge under notions of uniformity or equity, but it seems improper to challenge the credit under review in this case. If the decision stands, it creates tax planning uncertainty for all taxpayers subject to state and local income/franchise taxes.

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The holding of the Sixth Circuit in *Cuno v DaimlerChrysler* [2004 Fed App 0293P, CA-6, 9/2/04, appeal from NDOH decision 00-07247] cuts to the core of the economic development strategies of the state and local governments. The decision found in violation of the Commerce Clause of the US constitution was an investment tax credit offered by Ohio, for increased in-state investment. The credit is available to all business taxpayers meeting the technical requirements of the provision, not just to those incorporated in the state.

Incentives and credits offered to business taxpayers, chiefly to recruit and retain business activities in the jurisdiction, have become exceedingly popular, and often exceedingly complex, in the last two decades. The states are granted a broad authority to constitute their taxing systems within the bounds of the US constitution – the US Supreme Court allows that it is “a laudatory goal in the design of the tax system to promote investment that will provide jobs and prosperity to the citizens of the taxing State” [*Trinova Corp v Michigan Dept of Treasury*, 498 US 186 (1994)], and that such business subsidies “ordinarily impose no burden on interstate commerce, but merely assist local businesses” [*West Lynn Creamery Inc v Healy*, 512 US 186 (1994)].

But some of these state and local tax incentives do seem to violate the investment neutrality that is required by the Commerce Clause, in that they interfere with state-to-state business dealings. Is the investment tax credit in dispute in this decision one of those in violation of the Commerce Clause? If the *Cuno* reasoning stands or is extended outside of the Sixth Circuit (Ohio, Michigan, Kentucky, Tennessee), how will taxpayers and their advisors react?

Facts of the Case

A group of small-business owners from Toledo challenged the constitutionality of the Ohio investment tax credit [allowed by Ohio Rev Code Ann §5733.33(b)(1)]. DaimlerChrysler had used the credit to reduce its Ohio franchise tax liability by 13.5 percent of the amount of the new investment it made in a Toledo auto manufacturing plant, a \$280 million tax reduction. The \$1.2 billion investment constituted a net increase in the manufacturer's Ohio property, and it was made in an economically depressed part of the city.

The terms of this non-refundable credit allow a three-year carryforward of unused credits, but no carryback. The rate of the investment tax credit is 7.5 percent of new investment made outside of designated areas of economic distress. Ohio's package worked. DaimlerChrysler remodeled at an existing Toledo location to create a Jeep assembly facility, rather than building a new plant in Michigan.

The economic development package offered to DaimlerChrysler also included an abatement from the pertinent city and school district property taxes on the new investment. That abatement was upheld in *Cuno* and is not discussed in this paper. The District Court upheld the constitutionality of the investment tax credit, but the Sixth Circuit held that the credit violated the Commerce Clause non-discrimination test of *Complete Auto Transit v Brady* [430 US 274 (1977)], in that it favored expansion in Ohio, to the exclusion of expansion by Ohio-nexus businesses in other states.

The court used the standard that a state's taxing system was allowed under the Commerce Clause so long as "no state discriminatorily taxes the products manufactured or the business operations performed in any other state" [*Boston Stock Exchange v State Tax Commission*, 429 US 318 (1977)]. A discriminatory provision can be allowed, although this is a rare occurrence, if

“it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives” [*Oregon Waste Systems Inc v Dept of Environmental Quality*, 511 US 93 (1994); *Maine v Taylor*, 477 US 131 (1986)]. The credit was found to be discriminatory because it did not reduce Ohio taxes by a percentage of non-Ohio investment.

The *Cuno* suit was brought by a group of local business owners, financed by a Ralph Nader organization, who felt that they could not qualify regularly for the Ohio credit, and that DaimlerChrysler was unfairly advantaged by the provision. Nader’s group seems to have been looking for years for a “good test case” with which to attempt to stop the flood of tax incentives often targeted at large corporations, claiming that such economic development packages are used by the large entities to coerce state and local governments for tax cuts that must be made up by small, local businesses, and individuals.

The decision was written using some fairly inflammatory language, sounding somewhat like a Nader-esque charge. The opinion asserts that the view that the purpose of the Commerce Clause is to prevent economic protectionism – one state levying tariffs, say, against imported goods from another state – is too narrow, and that the body of Supreme Court Commerce Clause precedent is insufficient to describe the goals of the Clause effectively. It claims that a direct subsidy from the state could not be challenged constitutionally, although the quotation that the decision cites seems actually to *avoid* drawing such a conclusion [citation on page 11 of the decision to *New Energy Co of Indiana v Limbach*, 486 US 269, at 278].

Current Developments

The state, joined by DaimlerChrysler, asked that the case be heard by the entire panel of twelve Sixth Circuit judges, but this motion was denied. Several *amicus curiae* briefs were filed in

support of the rehearing, including those prepared by the Committee on State Taxation, the National Association of Manufacturers, and the US Chamber of Commerce. Federal legislation has been introduced that would protect credits of this sort from a Commerce Clause challenge.

The Tax Subsidy Environment

Any tax provision by nature is discriminatory. By identifying a transaction, asset, or action that is deserving of so-called legislative grace, a current tax liability increases or decreases. If the budgeting process and the taxing system overlap, in the short term a zero-sum game is created in that the resulting revenues from a tax reduction granted to one party must be made up with tax increases borne by others.

Legal Constraints. Each state's taxing system is unique, yet they all are subject to the constraints of the United States Constitution and Federal laws. While many clauses of the US Constitution are applied to state taxation, in the last two decades the courts have been interested in constitutional clauses that can be invoked to limit a state's authority to impose taxes. Generally, states are afforded wide latitude in creating a taxing structure, as long as the system meets all requirements of the US Constitution.¹

The Supremacy Clause of the Federal constitution confers superiority to Federal laws over state laws; that is, Federal laws are "the supreme law of the land" and trump state laws. If a state law or constitutional provision is in conflict with a Federal law, it is considered to be invalid. The Supremacy Clause is generally invoked in tax conflicts involving the dormant Commerce Clause.

¹ See especially Raabe, et al, *Federal Tax Research*, 7e [Thomson, 2006], chapter 9.

Under the Commerce Clause, Congress has the power to regulate commerce with foreign nations, among states, and with Native American tribes. This clause contains the most significant Federal limitation on a state's capacity to impose taxes. It grants powers to Congress and places constraints on the states' ability to tax interstate trade.

The Commerce Clause has a long history of Supreme Court actions. The interpretation of the clause as it now stands is based on *Complete Auto Transit Inc. v. Brady* [430 US 274 (1977)]. The case involved a tax imposed on a corporation for the privilege of conducting an interstate transportation business. The Court developed the four criteria now regarded as controlling whether a state may tax interstate commerce. A tax may be imposed if:

- the tax is applied to an activity with a substantial nexus (connection) with the taxing state;
- it is fairly apportioned;
- it does not discriminate against interstate commerce; and,
- the tax is fairly related to the services provided by the state.

The US and most state constitutions include an equal protection and/or a uniformity clause. These concepts are closely related and state courts often treat them as being interchangeable. These rules require that similarly situated persons or property be treated for tax purposes in a similar manner. Although the Fourteenth Amendment Equal Protection clause does not reference taxation specifically, it has been relied upon to determine whether tax provisions treat different taxpayers equally.

The Supreme Court has construed the Equal Protection Clause as barring states from creating arbitrary classifications for taxation. Yet, when the only Federal question is equal protection, the Court gives states wide latitude in delineating classifications in systems of

taxation. The state legislature is considered to be in a superior position for devising its taxing system on an equitable and uniform basis. As long as the legislature can justify its treatment of classes of taxpayers differently, the Court typically will not second-guess the wisdom of the state. Accordingly, the Supreme Court’s approach insulates state taxes from most challenges under the Equal Protection Clause.

The Commerce Clause’s call for an avoidance of interference in interstate business dealings was crafted when there were only a handful of states, income taxation (even very broadly defined) contributed insignificantly to the fisc, and most of the economy was agrarian and low-tech extraction and manufacturing. Its language does not match perfectly in a global economy, based significantly on services, communication, and transportation, in a country of almost 300 million people. Difficulties exist in dealing with the Clause in the context of internet and catalog sales, let alone of national and state borders opened up by means of business and transportation policies of the federal government itself.

Economic and Equity Concerns. A scholarly view of the Commerce Clause might describe it as promoting, if not requiring, investment neutrality as capital flows among the states.

Remembering the makeup of the so-called factors of production (land, labor and capital), investment neutral tax laws would not interfere with decisions about where a business should be located, how workers should be trained and paid, or how cash should flow from state to state.

Neutrality with respect to:	Arises in business decisions such as:
Land	Where a business should be located or expanded
Labor	Proper compensation and training of workers
Capital	Free flow of cash and loans from state to state

These issues are of interest to the states, and a competition arises among the states when large dollars are at stake, such as when jobs are created and people must use roads, schools, and security that are government financed. Since the mid-1980s, this competition has become formalized. Departments of economic development have been created by states and smaller jurisdictions, charged to recruit new business and to help existing local entities resist the recruiting efforts of others to “stay at home.” The tools of such an economic development strategy often are designed to accomplish the following.

- Recruiting, retention, and expansion of business operations
- Creation of new jobs, and improvement of the skill level of local employees
- Investment in new or “higher” tech property, plant, machinery, and equipment
- Growth in research and development activities
- Encouragement of entrepreneurship
- Targeted opportunities for groups of disadvantaged individuals

Tools of the Trade. Tax-based applications of an economic development strategy typically include tax **credits** and tax **incentives** as part of an array of tax-based inducements made available to businesses. Tax credits typically are added to the revenue code and are used to make the tax benefits available in an equitable manner to all taxpayers, in that the cash flow increases made available in this manner do not change among taxpayers subject to different marginal rates, are the same regardless of the type of business, and so on. Tax credits often are based on purchases of machinery and equipment by a business, research and development expenditures, new jobs created, or some combination of these factors. Some states limit the credits to investments in certain areas of the state (typically called enterprise or empowerment zones) while others (like Ohio) simply provide *larger* tax credits for investments in these areas.

As can be seen in Exhibit One, 22 of the states have offered tax credits based on machinery and equipment purchases, in a way that is very similar to Ohio's investment tax credit. Of states with a corporate income tax, only Alaska, Hawaii, and New Hampshire do not use broad-based income tax credits to encourage economic development of this sort.

Exhibit One: Current Investment-Type Credits of the States

State	Tax credit based on machinery and equipment purchases	Tax credit based on research and development expenditures	Tax credit based on new job creation	Tax credit based on new investment and new job creation
Alabama	➡		➡	➡
Alaska				
Arizona		➡		
Arkansas	➡ ²	➡	➡ ²	
California	➡	➡		
Colorado	➡			
Connecticut	➡	➡		➡
Delaware	➡	➡		
Florida			➡	
Georgia	➡		➡	
Hawaii				
Idaho	➡	➡	➡	
Illinois	➡			
Indiana		➡		➡
Iowa		➡	➡	
Kansas	➡	➡		
Kentucky	➡			➡
Louisiana		➡		➡
Maine	➡ ³	➡		➡
Maryland		➡		➡
Massachusetts	➡	➡		
Michigan				➡
Minnesota		➡	➡	
Mississippi		➡		➡

² Targeted to biotechnology companies

³ Targeted to high-tech activities

State	Tax credit based on machinery and equipment purchases	Tax credit based on research and development expenditures	Tax credit based on new job creation	Tax credit based on new investment and new job creation
Missouri				➡
Montana	➡	➡		
Nebraska				➡
Nevada ▪				
New Hampshire				
New Jersey	➡	➡		➡
New Mexico			➡	
New York	➡	➡	➡	➡
North Carolina	➡	➡	➡	
North Dakota		➡	➡	
Ohio	➡		➡	
Oklahoma	➡			➡
Oregon		➡		
Pennsylvania		➡	➡	
Rhode Island	➡	➡		
South Carolina			➡	
South Dakota ▪				
Tennessee				➡
Texas	➡	➡	➡	
Utah		➡		
Vermont		➡		
Virginia				➡
Washington		➡		
West Virginia	➡	➡		
Wisconsin		➡		
Wyoming ▪				
▪ No state-level corporate income tax.				

Tax incentives are much more discretionary as to their use, and they frequently are targeted to a specific type of business, or even a targeted business. Often, a line item is created in the government's budget specifying the maximum amount of benefits that a development department or other agency can parcel out to taxpayers, say through an application process following a recruitment effort, when the goals of the incentive are met. Typically, large-dollar

incentives must be approved in the negotiating process by the full legislature or one of its key committees. Incentives of this sort *are not* available to all taxpayers operating within the border, but only to those “recruiting targets” who qualify under the economic development guidelines.

While targeted incentives may include income tax credits, they may also provide for tax abatements or holidays from property, sales, or payroll taxes; tailored apportionment formulas; or, special offsets against non-income based taxes. Examples of targeted tax incentives include Virginia's \$1,000 income tax credit for new jobs created by the opening of a semiconductor plant by IBM and Toshiba in 1995. While the credit was (and is) available to other taxpayers, it was used primarily as a device to lure the IBM/Toshiba plant to Virginia. Similarly, Alabama used a series of targeted incentives including issuing tax exempt bonds and deductions of job development fees against income tax withholdings due to the state to lure Mercedes Benz to the state in 1993 [Brunoni, D. "Principles of Tax Policy and Targeted Tax Incentives," *State Tax Notes*, June 9, 1997]. In 1999, Alabama used a targeted incentive package including both tax and nontax incentives to lure Honda to the state.

Non-tax incentives often include below-market financing, cash grants for specified uses such as job training or computer purchases, and other inducements offered on a project-by-project basis. Examples of non-tax incentives include Virginia's Opportunity Fund (used by the Governor as a "deal closer"), Indiana's customized worker training program which reimburses companies up to \$200,000 for training and retraining employees, and Michigan's site development and infrastructure grants.

Tax credits typically do not require any special *ex post* approval by the legislature or governor, and they only seldom entail an application or notice process before the fact, (such as certifying that the activity is in an approved enterprise zone). Tax incentives, though, are

frequently negotiated by the parties and often then are subject to multiple levels of approval, i.e. to allocate the available funds for the economic development programs, say on a “first come” or by-geographic-area apportionment model. Credits often carry carryover provisions, while few incentives do so.

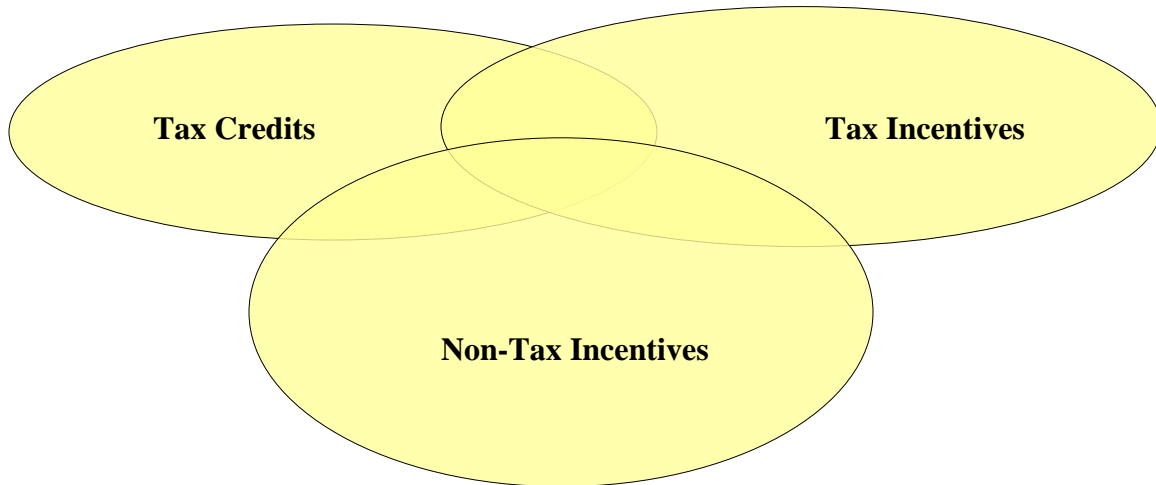
With respect to most incentive programs, and a few credits as well, the tax benefits are accompanied by obligations that the taxpayer must meet, such as a specified number of “new jobs” created in a time period, sometimes with limits as to wage levels, and length of service for those holding the jobs, e.g. “1,000 new jobs, minimum annual salary \$25,000, retained for eighteen months,” or “\$5,000,000 in new construction contracts in this neighborhood within two years.” Some of the incentives must be repaid to the government if these requirements are not met, under so-called Clawback provisions. For many years, the clawback rules had been only lightly enforced but, with falling revenues from a stalled economy facing most state and local governments, clawback payments (or renegotiations thereof) have become more common.

Using Credits and Incentives. The most effective economic development packages include both tax credits and incentives, as well as non-tax concessions, say improvements to a plot of land to be later developed by the taxpayer. In such a situation, a city might acquire, finance, or build roads and sewer lines on the taxpayer’s property, and it might work with an energy or communications utility to reduce the taxpayer’s cost of those necessities.

One might think of a dynamic subsidy package offered to the recruiting/retention target as resembling Exhibit Two. Some of the tax incentives might work like credits, some of the benefits might be targeted to a few identifiable businesses, and the non-tax items might offer direct subsidies or deductions against other obligations of the target. For example, payroll tax withholdings might partially offset a debt obligation to the state or to a participating lender.

Exhibit Two: Elements of an Economic Development Offer

ECONOMIC SUBSIDIES



In the last five years, there have been rumblings by “have-not” taxpayers, (those whose competitors have negotiated a subsidy package), to invalidate parts of the jurisdiction’s tax toolbox. For example, if two airlines are based in a county, and one threatens to relocate but changes its mind when receiving a property tax abatement incentive, the other will and should claim unfair treatment. This charge often is negotiated in the statehouse and does not become public knowledge, although threats of litigation under a state’s uniformity-of-tax or equitable-treatment clause often trigger the reaction.

Analysis

Currently used tax credits and incentives might be described as delineated in Exhibit Three, where the major distinctions entail whether:

- The item is a cash appropriation or a “tax expenditure,” and
- The item is a positive or negative incentive.

Exhibit Three: Forms of Government Subsidies by Type

Type of Subsidy	Direct Cash Appropriations	Tax Expenditures
Positive	Cash paid by the state to the taxpayer for making an investment. Examples Cash grant, Utilities/Assets provided	Tax subsidy from the state for making an investment. Examples Enterprise zone credit, Tax abatement if job creation goals are met
Negative	Cash penalty paid to the state for an investment outflow. Examples State-level tariff assessed on out-of-state sale or expansion	Tax penalty payable to the state for an investment outflow. Examples Out-of-state taxpayers limited to straight-line cost recovery, Higher tax rate schedule for taxpayer based out-of-state

The courts consistently have claimed that the Commerce Clause is violated when a jurisdiction adopts provisions that are characterized by the yellow/light-shaded boxes of Exhibit Three. A dual tax rate schedule or tariff system would have no chance of surviving a Commerce Clause challenge.

Even under this narrow (yellow/light box only) standard, there should be more successful challenges to state incentive packages under the Commerce Clause. For instance, why are the following items, commonly used tools by economic development agencies and legislatures, not also Commerce Clause violations? Encouraged by the investor’s loss in *Cuno*, one might anticipate that similar litigation soon will be seen, involving:

- An out-of-state taxpayer that is subject to a double-weighted sales factor, or sales-factor-only apportionment of business income. It is clear that adoption of such an approach to

income apportionment places the “missionary” taxpayer at a disadvantage. Only a minority of states still uses the three-equal-factors apportionment formula, while sales-factor-only apportionment is spreading quickly through the Midwest.

- The payment of a clawback penalty by a business that moves investment or jobs out-of-state before the targeted goals were met. Who will now sign an economic development deal that includes a clawback, when that provision is likely to be thrown out by a court upon a later review?

Conversely, courts have not seen a Commerce Clause violation in the two “positive” type incentives (the white and green/dark-shaded boxes of Exhibit Three). Although not likely examining the positive incentives in great depth, and hearing cases presented a decade or more ago, courts have been neutral, silent, or slightly encouraging of the use of cash payments and tax expenditures to build up a local economy. Local lawmakers have been left with the decision to say, for example, whether a \$5 million tax break should go to one of the world’s largest corporations in the form of an employee training or outplacement grant, to existing local businesses potentially in need of pricing support, or to tax incentive districts. Courts have left the goals and structure of a state or local taxing system to be determined and implemented by citizens living in those jurisdictions.

That is, until *Cuno*. The Sixth Circuit decision takes away the ability of the state to use the tax credit system to encourage in-state investment, claiming that tax credits of this sort are discriminatory toward interstate commerce in that “the tax credit involves state regulation of interstate commerce through its power to tax.” A distinction of this sort seems meaningless, in that the use of a non-credit incentive involves the state’s *power to spend* tax dollars and should

thus be subject to the same standard. If there is no challenge to the appropriation process, then the use of tax-based incentives also should be safe from Commerce Clause challenges.

In fact, the court acknowledges that, by using a direct cash grant approach, the same result constitutionally could have been accomplished. We believe that new Commerce Clause challenges should focus on the use of non-credit incentives, the most discretionary of the development department's tax weapons. But going forward, unless and until *Cuno* is reversed, all tax credits and incentives in the green/dark box in Exhibit Three, that part of the economic development toolkit that has perhaps most been used and developed in a manner that satisfies the states, are in jeopardy – immediately, not only in Ohio but in the other Sixth Circuit states as well, and more broadly if this turns out to be the “test case” that some hope it is.

Conclusion

The Sixth Circuit *Cuno* decision challenges the US constitutionality of the use of tax credits to accomplish economic development goals of a state or local tax jurisdiction. The *Cuno* opinion wants the Ohio tax law to operate more like a federal system, allowing a credit and thereby subsidizing out-of-state investments, as well as those made in-state. Perhaps on appeal the state should use an argument used in *Oregon Waste Systems* which they did not employ in the first round of cases. This logic argues that tax provisions always create some level of discrimination, but that it is an acceptable level of discrimination under the Commerce Clause because the market does not provide a nondiscriminatory solution to the problems of distressed neighborhoods and the swings of the business cycle. Furthermore, the argument is that a government's proper use of its tax system is to provide such solutions.

Commerce Clause discrimination was manifested in *Cuno* because the taxpayer was granted no tax reduction from an expansion in another state. Not only does this rule constitute a double negative, it presumes a reach of the Ohio tax system beyond what the rest of the US constitution allows.

As a result, in the short term, legislatures might tend toward an increase in “positive, cash-based” incentives, the one remaining white box in Exhibit Three. But this will present political difficulties – budget-makers almost always find tax expenditures preferable to actual expenditures. Tax planners now also should favor cash-based items in their negotiations, in addition to looking for *Cuno*-based refund opportunities where credits might be generated for out-of-state activities covered by state-focused credits.

Many tax incentives seem to us ripe for a challenge under Commerce Clause or state equity and uniformity provisions. But a full *Cuno* limitation on tax credits seems:

- Too broad of an application of the dormant Commerce Clause and its case law, and
- Too binding in its application on business recruiting and retention strategies of the states.

We do not address here the efficacy of the recruiting strategies that involve tax breaks for those who locate or relocate chiefly as part of a high-stakes competition. Academic literature questions whether the jurisdictions achieve the full economic growth that the recruiting packages promise, but the use of such tools is perhaps stronger than ever. *Someone* believes that the cross-border recruitment strategy works.

In a global and competitive economy, state and local jurisdictions need more, not less, freedom to craft an effective taxing system. Pure non-discrimination due to the forced evolution of identical tax systems among the jurisdictions is neither practical nor desirable, and it is certainly not politically attainable. But *Cuno* brings further uncertainty to the already complex

world of state and local taxation. Why would not a similar charge lead to the following, similarly nonsensical results?

- The elimination of all job-oriented incentives. “If one state can’t offer tax credits for computer training, then, to be non-discriminatory, no state can offer such training.”
- The elimination of differential tax rate schedules. “It is unconstitutional for our neighboring state to apply a nine percent tax rate, when our rate is ten percent. They must increase their rates.”
- The removal of a state’s ability to structure any part of its taxing system. “Wyoming must add an income tax on corporations, because Colorado has one.”

