

# State & Local Perspective

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## Constitutionality of State Tax Incentives Under the Commerce Clause

*By Rick J. Shapiro*

Over the years, state legislatures have enacted various tax incentives in order to spur economic development and attract certain business within its borders. These tax incentives take a variety of forms from credits and abatements to exemptions and deductions. However, in enacting such incentives, a state must be careful that the incentive package does not discriminate against interstate commerce. In that regard, a recent case involved whether an Ohio investment tax credit and personal property tax exemption intended to further economic development in the state violated the Commerce Clause of the U.S. Constitution.<sup>1</sup>

This column discusses how the Sixth Circuit Court of Appeals decided whether the state and local tax incentives passed constitutional muster under the Commerce Clause of the U.S. Constitution.<sup>2</sup> It then comments on the ramifications of the decision.

In 1998, DaimlerChrysler entered into an agreement with the City of Toledo to construct a new vehicle-assembly plant near the company's existing facility. DaimlerChrysler estimated that it would invest approximately \$1.2 billion in this project, which would provide the region with several thousand new jobs. In return, the City and two local school districts agreed to give DaimlerChrysler a 10-year 100-percent property tax exemption. In addition, the investment qualified for a state investment tax credit against the state corporate franchise tax of 13.5 percent of the expenses of the taxpayer's cost of the new manufacturing machinery and equipment over the county average for such new manufacturing machinery and equipment. The total value of the tax incentives provided to Daimler Chrysler was estimated to be \$280 million.

The plaintiffs, a citizens' group, brought the action contending that the investment tax credit and the personal property tax exemption violated the Com-

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merce Clause of the U.S. Constitution. Secondly, the plaintiffs claimed that the incentive package violated Ohio's Equal Protection Clause.<sup>3</sup> Interestingly, the court does not discuss the jurisdictional issue of standing concerning these plaintiffs. Presumably, the plaintiffs argued that they have been harmed by incurring larger tax burdens than they otherwise would have incurred but for the tax incentive packages received by DaimlerChrysler (and other businesses) that reduced DaimlerChrysler's tax liability. Yet, in the absence of the proof of actual harm, even this rationale may not confer jurisdiction for these plaintiffs.

Another issue not discussed in this opinion is that the defendants removed the case from state court to federal court. Under the circumstances of this case, one would expect the plaintiffs to have attempted to file the case in federal court, but here just the opposite occurred. The plaintiffs filed the action in state court (perhaps attempting to comply with the Tax Injunction Act) and the defendants removed the case to federal court. Again the court does not discuss whether federal jurisdiction was proper for this action.

The investment tax credit is a credit against a taxpayer's Ohio corporate franchise tax liability, and is equally available to in-state and out-of-state businesses. Nonetheless, the plaintiffs contended that the investment tax credit discriminated against interstate economic activity by coercing businesses already subject to the Ohio corporate franchise tax to expand locally rather than out-of-state. Specifically, the plaintiffs argued that any corporation currently doing business in Ohio, and therefore paying the state's corporate franchise tax in Ohio can reduce its existing tax liability by locating significant new machinery and equipment within the state, but it will receive no such reduction in tax liability if it locates a comparable plant and equipment elsewhere. As such, the plaintiffs contended that the economic effect of the Ohio investment tax credit is to impermissibly burden interstate commerce. On the other hand, DaimlerChrysler contended that state tax incentives, such as the Ohio investment tax credit, are permissible provided that they do not penalize out-of-state economic activity.

The court reviewed U.S. Supreme Court cases that invalidated tax schemes that encouraged the development of local industry by imposing greater burdens on economic activity taking place outside the state.<sup>4</sup> The court determined that the Supreme Court analysis in these decisions commanded the court to examine the practical effect of the challenged tax schemes and not to focus on the benefited or burdened party. In doing

so, the court rejected DaimlerChrysler's argument that there is a distinction for Commerce Clause purposes "between laws that benefit in-state activities and laws that burden out-of-state activity,"<sup>5</sup> with the former being permissible. Effectively, the court concluded that the practical effect of the investment tax credit is to "encourage further investment in-state at the expense of the development of other states."<sup>6</sup> As a result, the court ruled that the investment tax credit could not be upheld under the Commerce Clause of the U.S. Constitution.<sup>7</sup>

With respect to the personal property tax exemptions, the plaintiffs argued that the requirement to maintain a specified level of employment and investment in the state in order to qualify for the exemption subjected two similarly situated owners of Ohio personal property to differential tax rates. The plaintiffs contended that a taxpayer who agrees to focus its employment or investment in Ohio receives preferential treatment in the form of a tax break, while a taxpayer who prefers to preserve the freedom to hire or invest elsewhere does not.

The court reasoned that the conditions imposed on the exemptions did not independently burden interstate commerce. The court stated: "Contrary to plaintiffs' assertions, the conditions imposed on the receipt of the Ohio property tax are minor collateral requirements and are directly linked to the use of the exempted personal property ... . The statute does not impose specific monetary requirements, require the creation of new jobs, or encourage a beneficiary to engage in an additional form of commerce independent of the newly acquired property."<sup>8</sup>

Further, the court stated that the plaintiffs' argument regarding the personal property tax exemption overlooked the distinction between tax credits and exemptions. Unlike the investment tax credit that reduces pre-existing income tax liability, the personal property tax exemption simply permits a taxpayer to avoid tax liability for new personal property invested in Ohio. The court's distinction between the permissible personal property tax exemption and the impermissible investment tax credit does not seem to be a test that can be satisfactorily applied in all circumstances. For instance, if an out-of-state company with no nexus or tax liability in Ohio decides to construct a manufacturing plant in Ohio, this taxpayer may qualify for the investment tax credit. If the taxpayer never had an Ohio corporate franchise tax liability prior to constructing the plant, then under the court's reasoning the investment tax credit would not run afoul of the Commerce Clause because the credit was not used to reduce pre-existing income tax liability. Nonethe-

less, the court struck down the investment tax credit as unconstitutional.

Moreover, the breadth of this decision is unclear. If any state tax incentive that reduces pre-existing income is unconstitutional, then it is possible that a state that currently uses a three-factor apportionment formula of payroll, property and sales for computing the state income tax liability of a multi-state taxpayer may not change to a single sales factor for apportionment purposes. Generally speaking, a taxpayer that is capital intensive in a single state but that has multi-state sales would reduce its pre-existing income tax, if that state changed its apportionment formula from a three-factor formula to single sales factor. In other words, the single sales factor furthers economic development in a state by encouraging the investment in property and payroll in that state. At the same time, it penalizes out-of-state taxpayers without property and payroll in the state, but that have multi-state sales. Surely, the court did not intend to strike down these apportionment schemes as unconstitutional under the Commerce Clause. In fact, the U.S. Supreme Court has ruled

that a single sales factor apportionment formula is constitutionally valid under the Commerce Clause.<sup>9</sup> Nonetheless, the court's analysis in this decision suggests that a single sales factor apportionment formula violates the Commerce Clause.

This decision places a cloud on the future viability of tax incentives offered by many states. As a result, many state departments of economic development likely will be extremely conservative in developing new tax incentive programs. Because of the importance of these tax incentives to state economic development, more likely than not, this decision will not be the final chapter on this issue. A three-judge panel of the Sixth Circuit rendered the decision. The Ohio Attorney General has appealed the decision seeking a rehearing by the entire Sixth Circuit. The full court's decision will be subject to appeal to the U.S. Supreme Court. If this decision ultimately is upheld, it will create an opportunity for Congress to take action to preserve the states' ability to offer tax incentive programs and compete for economic development. In fact, if you listen closely, you can hear the states knocking on Congress's door.

#### ENDNOTES

<sup>1</sup> *Cuno v. DaimlerChrysler, Inc.*, CA-6, 383 F3d 379 (2004), amended by 386 F3d 738 (2004). Rehearing, en banc, den'd by Cuno v. DaimlerChrysler, Inc., CA-6, 2005 U.S. App. LEXIS 1750 (Jan. 18, 2005).

<sup>2</sup> The U.S. Constitution authorizes Congress to "regulate Commerce with foreign Nations, and among the several States." See U.S. Const. art. I, §8, cl. 3.

<sup>3</sup> The court ruled that the investment tax credit and the personal property tax exemption were not inherently suspect classifications, and only needed to satisfy rational basis review. As such, the court concluded that

neither incentive violated Ohio's Equal Protection Clause.

<sup>4</sup> *Boston Stock Exch. v. State Tax Comm'n*, SCt, 429 US 318, 97 SCt 599 (1977); *Maryland v. Louisiana*, SCt, 451 US 725, 101 SCt 2114 (1981); *Bacchus Imports, Ltd. v. Dias*, SCt, 468 US 263, 104 SCt 3049 (1984); *Westinghouse Elec. Corp. v. Tully*, SCt, 466 US 388, 104 SCt 1856 (1984); and *New Energy Company of Indiana v. Limbach*, SCt, 486 US 269, 108 SCt 1803 (1988).

<sup>5</sup> *Cuno*, supra note 1.

<sup>6</sup> *Id.*

<sup>7</sup> Interestingly, the Court did not discuss, and DaimlerChrysler did not raise, the point that the location of significant new equipment and jobs in Ohio resulted in a larger Ohio apportionment factor. Viewed in that light, the investment tax credit arguably offsets a penalty for businesses to make investments in Ohio. Also, the reality is that DaimlerChrysler would probably have been the recipient of a tax credit in whatever state it determined to make its investment in a new plant and equipment.

<sup>8</sup> *Cuno*, supra note 1.

<sup>9</sup> *Moorman Manufacturing Co. v. Bair*, SCt, 437 US 267, 98 SCt 2340 (1978).

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