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State Investment Tax Credits, the Commerce Clause, and *Cuno v. DaimlerChrysler*

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Summary

Many states offer tax incentives to companies that invest or expand business operations in the state. In a 2004 decision, *Cuno v. DaimlerChrysler*, the U.S. Court of Appeals for the Sixth Circuit addressed the constitutionality of two such incentives. The court held that Ohio's investment tax credit violated the Commerce Clause of the U.S. Constitution, but that its property tax abatement scheme did not. Approximately 40 states have credits similar to the one struck down in *Cuno*. The Economic Development Act of 2005 (H.R. 2471 and S. 1066, 109th Congress) has been introduced to give states the authority to offer tax incentives like Ohio's investment tax credit.

Like most states, Ohio provides various tax incentives to encourage businesses to locate or expand operations in the state. Two of its incentives, the investment tax credit and property tax abatement scheme, were the subject of a recent court case, *Cuno v. DaimlerChrysler*.[1] Ohio's investment tax credit is a non-refundable credit against the state's corporate franchise tax. The credit may be claimed by a taxpayer who purchases new manufacturing machinery and equipment that is installed in Ohio.[2] It is calculated using a formula that factors in the amount that the new property's costs exceed the average amount spent on new property in the county where the property is installed. Any unused credit may be carried forward for three years. Under Ohio's property tax abatement scheme, Ohio municipalities may offer an abatement to a business that agrees to "establish, expand, renovate, or occupy a facility and hire new employees, or preserve employment opportunities for existing employees" in economically depressed areas.[3] The exemption may be granted for up to ten years and for up to 75% of the property's assessed value. The 75% limit may be raised if the affected school districts agree.

In 1998, DaimlerChrysler and the City of Toledo entered into an agreement under which the company would construct a new vehicle-assembly plant in exchange for a

[1] 386 F.3d 738 (6th Cir. 2004), *rev'g in part and aff'g in part* 154 F. Supp. 2d 1196 (N.D. Ohio 2001), *rehearing, en banc, denied by* 2005 U.S. App. LEXIS 1750 (6th Cir. 2005).

[2] Ohio Rev. Code Ann. § 5733.33.

[3] Ohio Rev. Code Ann. § 5709.62.

ten-year property tax exemption. Additionally, the company's investments would qualify for Ohio's investment tax credit. The tax incentives were valued at $280 million.

In 1998, taxpayers from Ohio and Michigan brought suit against DaimlerChrysler, the State of Ohio, the City of Toledo and several other defendants, alleging, among other things, that the tax incentives violated the Commerce Clause of the U.S. Constitution.[4] As discussed below, the U.S. district court held that both incentives were constitutional, while the U.S. Court of Appeals for the Sixth Circuit held that the investment tax credit violated the Commerce Clause but the property tax abatement did not.

Commerce Clause

The Commerce Clause grants Congress the power to regulate interstate commerce. Congress' authority to regulate interstate commerce has been described as plenary and limited only by other constitutional provisions.[5] On the flip side of the issue, the Supreme Court has long held that the states may not unduly burden interstate commerce in the absence of federal regulation. This restriction is founded in what is referred to as the dormant Commerce Clause. A state tax provision does not violate the dormant Commerce Clause if four qualifications are met: (1) the activity taxed has a substantial nexus with the taxing State; (2) the tax is fairly apportioned to reflect the degree of activity that occurs within the State; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to benefits provided by the state.[6]

In the *Cuno* case, the only issue with respect to the Commerce Clause was whether the tax incentives were discriminatory. There is no simple definition of the term "discriminatory." Instead, the Supreme Court has provided general principles, which then must be applied to the specific tax at issue. For example, the Court has declared that a "fundamental principle" of the Commerce Clause is that states may not "impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business."[7] Another general rule is that a state may use its tax system to encourage intrastate commerce and may compete with other states for interstate commerce so long as the state does not "discriminatorily tax the products manufactured or the business operations performed in any other [s]tate."[8]

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[4] In tax cases where the plaintiff is a party other than the taxpayer who is contesting the tax due, an important issue is whether the plaintiff has standing to bring the suit. In this case, it appears the defendants conceded that one plaintiff business had standing since it risked losing property through a governmental taking due to Toledo's agreement with DaimlerChrysler. The State of Ohio's Petition for Rehearing at 9, Cuno, 386 F.3d 738. Due to changes in that plaintiff's circumstances (it lost the eminent domain case and vacated its property), Ohio argued in its petition to the Sixth Circuit for en banc review that the case should be dismissed because no taxpayer had standing. *Id.* at 9-10. The court denied the motion to review the case en banc. Cuno, 2005 U.S. App. LEXIS 1750 (6th Cir. 2005).

[5] *See* e.g., Prudential Insurance Co. v. Benjamin, 328 U.S. 408, 434 (1946).

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

[7] Boston Stock Exchange v. State Tax Comm'n, 429 U.S. 318, 329 (1977).

[8] Id. at 336-37.

The Supreme Court and other federal courts have not addressed whether an investment tax credit similar to the one at issue in *Cuno* is discriminatory. Thus, the district court and court of appeals were left to look at the general principles found in the Court's decisions and analogize the Ohio tax incentives to those in the prior cases. As shown by the opposite outcomes of the two courts with respect to the investment tax credit (discussed below), it is possible to come to different conclusions on the meaning of the Supreme Court's prior cases. The decisions in *Cuno* broadly represent two viewpoints of the Court's jurisprudence.[9] The district court's decision represents the idea that the purpose of the Commerce Clause is to prevent economic protectionism by the states; i.e., prevent states from helping in-state businesses by penalizing out-of-state businesses. The decision by the court of appeals represents the view that the Clause's purpose is to encourage free trade by limiting the state's ability to use its taxing power to coerce taxpayers into conducting business in that state. As seen in the two opinions, there is support in the Supreme Court's prior decisions for both interpretations; however, absent activity by the Supreme Court, the opinion by the court of appeals is controlling.

Cuno v. DaimlerChrysler

District Court. The U.S. district court granted the defendants' motion to dismiss the case for failure to state a claim. Among other things, the court found that neither the investment tax credit nor the property tax exemption violated the Commerce Clause. The court began by noting that the Supreme Court has explained that a state may use its taxing system to compete with other states for a share of interstate commerce so long as the state does not discriminatorily tax business operations conducted in the other states.

The court then described what it believed were the two types of state taxation schemes that the Supreme Court had found to be discriminatory. First, states could not tax goods imported from other states without imposing a tax on in-state goods. The court found this was not an issue with the Ohio incentives. Second, a state's tax could not be based on what proportion of a business' activities were carried on in the state as compared to business in other states. The court described the tax scheme in *Westinghouse Electric Co. v. Tully*[10] as the "paradigmatic example" of what was not allowed.[11] In that case, New York's corporate franchise tax combined the income from a subsidiary engaged in exports with the income of its parent company, with the tax assessed against the parent. To encourage in-state business activity, New York offered a credit that lowered the effective tax rate on the combined income as the subsidiary's exports from New York increased relative to those from other states. The court noted that the New York credit was similar to the Ohio incentives because an increase in New York activity would increase the New York credit amount and an increase in Ohio activity would increase the Ohio incentive amounts. However, the court made what it considered to be an important distinction

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[9] For further discussion, see Peter D. Enrich [plaintiffs' attorney in *Cuno*], "Saving the States From Themselves: Commerce Clause Constraints on State Tax Incentives for Business," 110 Harv. L. Rev. 377 (1996); Clayton P. Gillette, "Business Incentives, Interstate Competition, and the Commerce Clause," 82 Minn. L. Rev. 447 (1997); testimony from the hearing on the *Cuno* case held by two subcommittees of the House Judiciary Committee (May 24, 2005), which is available at [http://judiciary.house.gov/Oversight.aspx?ID=164].

[10] 466 U.S. 388 (1984).

[11] Cuno, 154 F.Supp.2d at 1203.

between the two cases: while an increase in activity conducted outside New York would decrease the amount of the New York credit, an increase in activity conducted outside Ohio would not decrease the benefits of the Ohio tax incentives. As a result, the court did not find the Ohio incentives to be discriminatory.

Sixth Circuit Court of Appeals. The plaintiffs appealed the district court's decision. The U.S. Court of Appeals for the Sixth Circuit held that the investment tax credit violated the Commerce Clause, and reversed this part of the lower court's decision. The appeals court upheld the district court's holding with respect to the property tax exemption.

Investment Tax Credit. The court found that the investment tax credit was discriminatory because it coerced businesses that are subject to the Ohio franchise tax to expand in Ohio rather than in another state. First, the court rejected the defendants' argument, which was accepted by the district court, that prior Supreme Court opinions had held that only two types of taxes were unacceptable: those that functioned as tariffs and those that determined the taxpayer's effective tax rate using both in-state and out-of-state activities. The court characterized this view as being "primarily concerned with preventing economic protectionism," and the court rejected this approach because it "rests on the distinction between laws that benefit in-state activity and laws that burden out-of-state activity."[12] The court described this distinction as "tenuous" since the Supreme Court had stated that "virtually every discriminatory statute . . . can be viewed as conferring a benefit on one party and a detriment on the other, in either an absolute or relative sense."[13]

Instead, the appeals court compared the Ohio tax incentives to state tax schemes that the Supreme Court had found to be discriminatory because the "schemes were the state using its power to tax an in-state operation as a way to encourage further investment in the state at the expense of development in other states."[14] The court looked at three cases:

- *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318 (1977), where the Court invalidated part of a New York securities transfer tax. New York imposed a tax on a transfer of securities if a taxable event occurred in the state. Since New York was the only state that taxed securities transfers, the tax placed New York brokers at a disadvantage. The state created incentives to encourage New York sales: if a sale occurred in New York, then nonresidents were taxed at a lower rate and both residents and nonresidents could not be taxed above a certain amount. The court of appeals quoted the Supreme Court as finding that the incentives "foreclosed tax-neutral decisions" and that New York was improperly using "its power to tax an in-state operation as a means of requiring [other] business operations to be performed in the home state,"

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[12] Cuno, 386 F.3d at 745.

[13] *Id.*

[14] *Id.*

which was "wholly inconsistent with the free trade purpose of the Commerce Clause."[15]

- *Maryland v. Louisiana*, 451 U.S. 725 (1981), where the Supreme Court invalidated a Louisiana severance tax credit that favored in-state natural gas producers. The appeals court quoted the Supreme Court as finding that since the credit "favored those who both own [offshore] gas and engage in Louisiana production" and that the "obvious economic effect of this Severance Tax Credit [was] to encourage natural gas owners involved in the production of [offshore] gas to invest in mineral exploration and development within Louisiana rather than to invest in further [offshore] development or in production in other States," the credit "unquestionably discriminated against interstate commerce in favor of local interests."[16]

- *Westinghouse Electric Corp. v. Tully*, which was discussed above in the section on the district court's opinion and was distinguished by that court. The court of appeals quoted the Supreme Court as stating that the tax scheme "penalized increases in the [export] shipping activities in other states," which meant it placed "a discriminatory burden on commerce to its sister States."[17]

The court of appeals found the Ohio credit to be analogous to these other tax incentives in that it coerced taxpayers into making in-state investments. This was because the credit reduced the business' pre-existing franchise tax liability. That is, a business with activities in Ohio would be subject to the state's franchise tax regardless of whether the business made an investment in new property eligible for the tax credit. That business could, however, reduce its existing franchise tax liability by making new investments that qualify for the tax credit. On the other hand, if the business chose to make the new investments outside of Ohio, it would not reduce its Ohio franchise tax liability. This meant, in the court's view, that Ohio was using its power to tax in a way that discouraged investment outside of Ohio. As a result, it held the credit was discriminatory and enjoined Ohio from administering the credit (however, this order has been stayed; see the "Supreme Court" section, below).

Property tax exemption. Like the district court, the court of appeals held that the property tax exemption did not violate the Commerce Clause. The appeals court found that the conditions for exemption were permissible because they directly related to the use of the exempted property. Furthermore, unlike the tax credit, the exemption was not coercive because it did not reduce taxes that the company would owe regardless of whether the company made the new investments in Ohio. Instead, the exemption only allowed the taxpayer to escape taxation on the new investment. In other words, the incentive was not coercive because a taxpayer who did not make any new Ohio

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[15] *Id.* at 734.

[16] *Id.*

[17] *Id.* at 735.

investments was not subject to the property tax that the incentive abated. Additionally, a taxpayer would not lose the exemption if it made other investments outside of the state.

Supreme Court. The defendants intend to appeal the case to the U.S. Supreme Court.[18] Ohio has successfully petitioned the court of appeals to stay the district court's decision until the Supreme Court decides whether to hear the case. Thus, taxpayers may continue to claim the Ohio tax credit for the time being. If the Supreme Court decides not to hear the defendants' appeal, then the appeals court's decision stands and is applicable to all the states in the Sixth Circuit.[19] These are Michigan, Ohio, Tennessee, and Kentucky. It appears that the other three states offer investment tax credits similar to the one invalidated in *Cuno*.

Legislation introduced in the 109th Congress. The Economic Development Act of 2005, H.R. 2471 and S. 1066, has been introduced to give states the authority to offer incentives like the one struck down in *Cuno*. The act would generally allow the states to provide discriminatory tax incentives if they are for economic development purposes. An economic development purpose would include any legally permitted activity for attracting, retaining or expanding business activity, jobs, or investment in a state. Some incentives would not be allowed, including those that depend on state of incorporation or domicile; require the recipient to acquire or use services or property produced in the state; are reduced as a direct result of an increase in out-of-state activity; result in a loss of a compensating tax system; require reciprocal tax benefits from another jurisdiction; or reduce a tax not imposed on apportioned interstate activities. The act would apply to all qualifying tax incentives, regardless of their date of enactment.

Legislation introduced in the 108th Congress. S. 2881 would have allowed the states to offer tax incentives for investment in new machinery or equipment in the state. The legislation would have explicitly stated that the state's action would not be an undue burden on interstate commerce. H.R. 5427 would have allowed the states to offer tax incentives for investment in the acquisition, construction, installation, and rehabilitation of improvements, real estate, fixtures, equipment, and facilities located in the state. Like S. 2881, the legislation would have explicitly stated that the state's actions did not unduly burden interstate commerce.

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[18] [http://tax.ohio.gov/divisions/communications/information_releases/cft200403.stm].

[19] It appears that similar cases have been brought in at least three other states: Nebraska [DeCamp v. Nebraska, No. CI041981 (Neb. 3d Dist. Ct.)], Minnesota [Olson v. Minnesota, Ramsey County District Court, Second Judicial District, Case No. 62-C8-05-2727], and North Carolina [Blinson v. North Carolina, complaint available at [http://www.ncicl.org/LITIGATION/complaint.html]].