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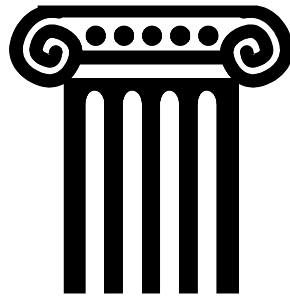

Foreword: *DaimlerChrysler v. Cuno* and the Constitutionality of State Tax Incentives for Economic Development

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by

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In 2004, in *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738 (6th Cir. 2004), the Sixth Circuit invalidated the Ohio investment tax credit on dormant Commerce Clause grounds while upholding a property tax waiver by the City of Toledo and local school boards against a similar challenge. The Supreme Court granted DaimlerChrysler's petition for certiorari on the Ohio investment tax credit issue only while ordering the parties to brief whether the *Cuno* plaintiffs have standing to sustain their challenge. The *Cuno* plaintiffs' petition for certiorari on the property tax waiver issue remains pending. On October 7, 2005, scholars and other experts gathered at the University of Minnesota Law School to discuss issues raised by the *Cuno* case. The purpose of this essay is to introduce and provide background for essays produced in connection with a conference on *DaimlerChrysler Corp. v. Cuno*, as the case is known on the Supreme Court's docket.

FOREWORD: *DAIMLERCHRYSLER V. CUNO* AND THE CONSTITUTIONALITY OF STATE TAX INCENTIVES FOR ECONOMIC DEVELOPMENT

by

Kristin E. Hickman[*] and Sarah L. Bunce[**]

The dual sovereignty of federal and state governments is a hallmark of American governance. One of the most fundamental elements of sovereignty is the power to tax. Yet for the republic to function as the founders intended, that power cannot be unlimited. Rather, the States must employ that power with due recognition for requirements and limitations imposed not only by their own constitutions but also the United States Constitution. Indeed, as the Supreme Court has noted on several occasions, there is "much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation."[1]

Against this backdrop, the Sixth Circuit Court of Appeals announced its decision in *Cuno v. DaimlerChrysler, Inc.*,[2] a case in which the plaintiffs as citizens and taxpayers challenged the constitutionality of two different Ohio tax incentives. The court ultimately declared a state-level investment tax credit to be in violation of the "dormant Commerce Clause" of the United States Constitution while upholding a municipal property tax waiver against the same challenge. The United States Supreme Court has now agreed to hear oral argument in this case and, potentially, to revisit the question of the constitutionality of state tax incentives for economic development.

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[1] Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457 (1959).

[2] 386 F.3d 738 (6th Cir. 2004).

In October 2005, scholars, economists, and other experts gathered in Minneapolis at an event co-sponsored by the University of Minnesota Law School and the Federalist Society for Law and Public Policy Studies to discuss issues raised by *DaimlerChrysler v. Cuno*, as the case is known on the Supreme Court's docket. To some extent, the debate is one of long standing. Scholars have written extensively both on the dilemma of state tax incentives and the dormant Commerce Clause[3] and on the efficacy and wisdom of state tax incentives as a mechanism for economic development.[4] The *Cuno* case has brought new attention to these old debates, however, and offers fresh fodder for consideration and commentary. Our purpose here is to introduce and provide background for the essays to follow, which in turn explore some of the many ideas discussed in Minneapolis.

The Facts

The story of the *Cuno* case is a familiar one in today's business climate. In the late 1990s, DaimlerChrysler decided to expand its capacity to build Jeeps. DaimlerChrysler already had a vehicle-assembly plant in Toledo, Ohio, and liked the idea of expanding its operations in that area. So DaimlerChrysler approached Toledo municipal and Ohio state government representatives to inquire about tax incentives that might be available in the event that the company chose to expand its facilities in Toledo rather than across the border in nearby Michigan.

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[3] *See, e.g.*, Peter D. Enrich, *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); Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives,* 81 CORNELL L. REV. 789 (1996); Kathryn L. Moore, *State and Local Taxation: When Will Congress Intervene?*, 23 J. LEGIS. 171 (1997); Edward R. Zelinsky, *Restoring Politics to the Commerce Clause: The Case for Abandoning the Dormant Commerce Clause Prohibition on Discriminatory Taxation*, 29 OHIO N.U. L. REV. 29 (2002-03).

[4] *See, e.g.*, Melvin L. Burstein & Arthur J. Rolnick, *Congress Should End the Economic War Among the States*, 10 STATE TAX NOTES 1895 (1995) ; Alan Peters & Peter Fisher, *The Failures of Economic Development Incentives*, 70 J. AMER. PLANNING ASSOC. 27 (2004); James R. Rogers, *State Tax Competition and Congressional Commerce Power: The Original Prudence of Concurrent Taxing Authority*, 7 REGENT U. L. REV. 103 (1996).

Two statutory tax incentive provisions proved useful in persuading DaimlerChrysler to develop in Ohio rather than Michigan.[5] Section 5733.33 of the Ohio Revised Code grants a taxpayer a non-refundable credit against Ohio corporate franchise tax if the taxpayer purchases new machinery and equipment and installs it in Ohio.[6] If the purchases are targeted for use in specific, economically depressed areas, the credit increases to 13.5 percent of the total investment; however, the credit is limited to $1 million unless the taxpayer increases its overall ownership of machinery and equipment in the state for a given tax year.[7] Separately, sections 5709.62 and 5709.631 of the Ohio Revised Code allow municipalities to offer personal property tax waivers, among other things, to businesses that agree to invest in facilities and job preservation or growth in designated enterprise zones certified by the state as economically depressed.[8] The waiver is calculated as a specified portion of the assessed value of new, tangible personal property.[9] With consent from the local school districts, the personal property tax exemption can exceed 75 percent of the taxpayer's total expenditure.[10] After working with local and state officials, DaimlerChrysler accepted a $280 million incentive package — a package that included the 13.5 percent investment tax credit against state corporate franchise tax and a ten-year, 100 percent personal property tax exemption — to build a new vehicle-assembly plant in Toledo.[11]

Charlotte Cuno, a self-described Toledo resident, homeowner, and taxpayer, joined several plaintiffs from Ohio and Michigan to bring suit against DaimlerChrysler, the State of Ohio, the City of Toledo, local school boards, and various individual government officials over that $280

[5] *See* Cuno, 386 F.3d at 741.
[6] Ohio Rev. Code Ann. § 5733.33.
[7] Cuno, 386 F.3d at 741.
[8] Ohio Rev. Code Ann. §§ 5709.62, 5709.631.
[9] *See* Ohio Rev. Code Ann. § 5709.62(C)(1)(a).
[10] *See id.* at § 5709.62(D).
[11] *See* Cuno, 386 F.3d at 741.

million incentive package.[12] The plaintiffs alleged that the state investment tax credit and local property tax exemptions granted to DaimlerChrysler as incentives to expand its business operations in Toledo discriminated against interstate commerce in violation of the Commerce Clause by "providing preferential treatment to in-state economic activity."[13]

The federal district court dismissed the plaintiffs' claims for failure to state a claim upon which relief may be granted, holding that neither the investment tax credit nor the property tax exemption violated the Commerce Clause.[14] On appeal, however, the Sixth Circuit found the investment tax credit, but not the property tax waiver, to be in violation of the dormant Commerce Clause of the United States Constitution.[15]

The Doctrine

Article I, section 8 of the United States Constitution grants Congress the power to "regulate Commerce . . . among the several States."[16] The goal of the Commerce Clause was to control economic rivalry among the states and to create "an area of trade free from interference by the States."[17] It was not, however, intended to eliminate the "power of the States to tax for the support of their own governments"[18] or to nationalize state taxing authority.[19]

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[12] Brief of Appellants at 4-5, Cuno v. DaimlerChrysler, Inc., 386 F.3d 738 (6th Cir. 2004) (No. 01-3960); *see also* Complaint for Declaratory and Injunctive Relief at 5-7, Cuno v. DaimlerChrysler, Inc., No. CI0200006084 (Lucas Co., Ohio Mar. 28, 2000). The plaintiffs were assembled by Ralph Nader in order to attack the incentive package as a form of "corporate welfare." *See* J.T. Young, *Benedict Arnold Courts*, WASH. TIMES, July 24, 2005, at B4.

[13] Brief of Appellants, *supra* note 12 at 12-13.

[14] Cuno v. DaimlerChrysler, Inc., 154 F. Supp. 2d 1196, 1203-04 (N.D. Ohio 2001), *aff'd in part, rev'd in part*, 386 F.3d 738 (6th Cir. 2004).

[15] Cuno v. DaimlerChrysler, Inc., 386 F.3d 738, 746-48 (6th Cir. 2004).

[16] U.S. CONST. art I, § 8, cl. 3.

[17] Freeman v. Hewit, 329 U.S. 249, 252 (1946).

[18] Gibbons v. Ogden, 9 Wheat. 1, 199 (1824).

[19] *See* James R. Rogers, *supra* note 4, at 126.

The Supreme Court has interpreted the Commerce Clause to provide more than an affirmative grant of power. The "negative" or "dormant" Commerce Clause prohibits states from acting in a manner that interferes with interstate commerce.[20] "No State, consistent with the Commerce Clause, may 'impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.'"[21] Given this limit on state power to tax interstate commerce, the Supreme Court has developed a four-prong test with which to analyze state taxation under the Commerce Clause. A state tax provision will satisfy Commerce Clause requirements if it (1) applies to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services and benefits provided by the State.[22]

The *Cuno* case will be merely the latest in a line of Supreme Court jurisprudence to apply these principles and consider the relationship between the Commerce Clause and state tax policy. Although different commentators analyzing the issue have discussed several of the Court's such cases, the *Cuno* court focused its analysis on three that it felt particularly compelled the conclusions reached. In all of these cases, only the third, antidiscrimination prong of the above four-part test was at issue, as was the case in *Cuno*.

The first of these cases is *Boston Stock Exchange v. State Tax Commission*.[23] In *Boston Stock Exchange*, the Court considered the constitutionality of an amendment to New York's securities transfer tax statute. Before the amendment, the transfer tax was neutrally applied to all stock transactions with a New York nexus, regardless of where the sale of the stock actually occurred. The constitutionality of the original transfer tax was not in question. The

[20] *See* Quill Corp. v. North Dakota, 504 U.S. 298, 309 (1992).

[21] Boston Stock Exchange v. State Tax Comm'n, 429 U.S. 318, 329 (1977) (quoting Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 458 (1959)).

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

[23] 429 U.S. 318 (1977).

amendment, by contrast, was designed to encourage in-state transfers and "ease the competitive disadvantage of the tax on New York securities markets."[24] The amendment reduced the securities transfer tax for non-residents on stock sales executed in New York and also capped the tax liability for all taxpayers on each New York sale. Meanwhile, out-of-state stock sales with a New York nexus were subject to the full transfer tax. Stock exchanges located in other states complained that the amendment, by reducing the tax on in-state sales only, diverted business from them to the New York exchanges as customers sought to lower their New York transfer tax burdens.

The Court held the amendment created a discriminatory burden on interstate commerce in violation of the Commerce Clause.[25] Rejecting the notion that the statute was "compensating legislation" enacted to neutralize the competitive advantage of regional stock exchanges, the Court viewed the amendment as "foreclos[ing] tax-neutral decisions" by creating "a financial advantage to sales on the New York exchanges at the expense of the regional exchanges."[26] By diverting securities sales from the "most economically efficient channels," New York had impermissibly "us[ed] its power to tax an in-state operation as a means of 'requiring (other) business operations to be performed in the home State.'"[27] The Court concluded the diversion of interstate commerce and the foreclosure of tax-neutral decisions were "wholly inconsistent with the free trade purpose of the Commerce Clause."[28]

In reaching its decision, however, the Court made the following observation:

> Our decision today does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate

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[24] Boston Stock Exch., 429 U.S. at 325 n.7.
[25] *See id.* at 332.
[26] *Id.* at 331.
[27] *Id.* at 336 (quoting Pike v. Bruce Church, Inc., 397 U.S. 137, 145 (1970)).
[28] *Id.* at 336.

> commerce and industry. Nor do we hold that a State may not compete with other States for a share of interstate commerce; such competition lies at the heart of a free trade policy. We hold only that in the process of competition no State may discriminatorily tax the products manufactured or the business operations performed in any other State.[29]

Thus, the Court remained open to the use of state taxing authority to compete for interstate commerce. The Court, unfortunately, provided no examples of competitive tax provisions that would not be viewed as discriminatory.

The Court subsequently addressed a constitutional challenge against Louisiana's "First-Use Tax" in *Maryland v. Louisiana*.[30] The tax in question was imposed on the "first use" of any raw natural gas imported into Louisiana and was equal to a severance tax imposed on Louisiana gas producers. The purpose of the First-Use Tax was to equalize competition between Louisiana-produced gas subject to the severance tax and gas produced elsewhere not subject to the severance tax; but Louisiana also provided a number of exemptions and credits from the First-Use Tax that were available only to local enterprises. Gas used for particular purposes inside Louisiana was exempt from the First-Use Tax entirely. Taxpayers subject to both the First-Use Tax and the severance tax were allowed a tax credit equal to the amount of the First-Use Tax to be applied against the severance tax owed. Other credits were available if the end use as well as the first use of the gas was in Louisiana. As a result of these various exemptions and credits, most Louisiana consumers were insulated from the effect of the First-Use Tax while out-of-state gas consumers enjoyed no such protection.

In holding the First-Use Tax unconstitutional under the Commerce Clause, the Court assessed the tax "in light of

[29] *Id.* at 336-37.
[30] 451 U.S. 725 (1981).

its actual effect."[31] According to the Court, the severance tax was clearly within Louisiana's taxing authority; and the Court seemed to suggest that, theoretically, a tax might be structured as a corollary to that severance tax, much as many states employ complementary sales and use tax regimes, to assure uniform treatment of natural gas to be consumed in Louisiana.[32] The various credits and exemptions embedded in the Louisiana first use tax, however, destroyed any such view of the First-Use Tax. Through those credits and exemptions, the First-Use Tax "unfairly discriminates against purchasers of gas moving through Louisiana in interstate commerce."[33] Such a result, the Court concluded, "unquestionably discriminate[s] against interstate commerce in favor of local interests."[34]

The final link in the chain of jurisprudence relevant to the Sixth Circuit is *Westinghouse Electric Corporation v. Tully*, in which the Court struck down a New York franchise tax provision designed to give corporations a credit for income derived from Domestic International Sales Corporation (DISC) exports.[35] DISCs were pass-through entities for federal income tax purposes, meaning that their income was taxed only to their shareholders and not at the entity level.[36] New York, at least at that time, did not tax distributions from a subsidiary to a parent corporation; so New York had to pursue a different approach with DISCs or forego ever taxing DISC income.[37] To address this problem, New York

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[31] Maryland v. Louisiana, 451 U.S. at 756.

[32] *See id.* at 758-59. As the Court observed, use taxes are constitutional as a compensatory corollary to sales taxes, with the ultimate goal of use taxes being to equalize the cost of in-state and out-of-state goods consumed inside a state. *See id.* The Court rejected the First-Use Tax as a compensatory corollary to the severance tax on the ground that a severance tax is imposed for the privilege of removing resources from a state's soil, and Louisiana had no interest in land outside its borders from which the imported gas was removed. *See id.* Yet the Court then recognized the validity of imposing taxes on imported goods to ensure equal treatment for similarly situated taxpayers and suggested that it was the credits and exemptions and not the mere imposition of the tax that doomed the Louisiana First-Use Tax. *See id.* at 759.

[33] *Id.* at 760.

[34] *Id.* at 756.

[35] 466 U.S. 388, 401 (1984).

[36] DISCs were a creation of federal tax code provisions that have since been repealed. *See id.* at 391-92 (discussing these provisions.)

[37] *See id.*

enacted provisions consolidating each DISC with its parent entity for franchise tax purposes. To promote increased export activity, however, New York adopted an offsetting franchise tax credit based on a ratio of New York export income to total export income. With the use of this ratio, the greater the income generated by a DISC from New York exports, the greater the tax credit.

Westinghouse, a Pennsylvania taxpayer subject to New York franchise tax and owner of a Delaware-based DISC, sued. Under the new provisions, Westinghouse had to recognize all of the income from its DISC in its taxable income for New York franchise tax purposes but was ineligible for any corresponding credit. Westinghouse alleged that the credit awarded for exports by New York DISCs unconstitutionally discriminated against out-of-state taxpayers with DISCs located elsewhere. After illustrating the application of the tax credit, the Court concluded the credit "[wa]s awarded in a discriminatory manner" based on business conduct within the state. [38]

Although *Boston Stock Exchange* and *Maryland v. Louisiana* both involved taxes on particular transactions in interstate commerce rather than a general income tax, the *Westinghouse* Court deemed this distinction to be irrelevant.[39] The Court saw no constitutional significance in the formally distinguishable but economically identical cases of a 70% credit against a general income tax for shipments in interstate commerce to other states and a 30% tax imposed upon shipments in interstate commerce from other states. Moreover, the Court discounted any distinction between diverting new business into the state, the purported effect of the taxes in *Boston Stock Exchange* and *Maryland v. Louisiana*, and preventing business from leaving the state, which New York claimed to be doing. "Whether the discriminatory tax diverts new business into the State or merely prevents

[38] *Id.* at 401 (1984).
[39] *See id.* at 404.

current business from being diverted elsewhere, it is still a discriminatory tax that 'forecloses tax-neutral decisions.'"[40]

The Court has acknowledged that its case-by-case approach toward policing the boundary between the Commerce Clause and state tax policy has resulted in "much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation."[41] Indeed, scholars have struggled with the implications of these and similar cases for state tax and economic development policies. Edward Zelinsky has argued that the distinction between discriminatory and nondiscriminatory state taxation as defined by the Court is indeterminate, with "no convincing basis under the dormant Commerce Clause for declaring some state taxes discriminatory and others not."[42] Zelinsky suggests that even the most basic decision of a state to reduce its general tax rates in an effort to attract new business would be susceptible to invalidation under the Court's current dormant Commerce Clause analysis.[43] Further, though the Court thus far has distinguished tax exemptions and credits from direct subsidization, Zelinsky charges that the two are economically indistinguishable and that the Court's antidiscrimination reasoning could apply equally to the latter.[44] Peter Enrich acknowledges this "slippery slope" yet suggests that the Court will use its discretion on a case-by-case basis to avoid "needless intrusions upon state [tax] policymaking."[45] Other scholars have carefully parsed the Court's rhetoric to seek a principled basis for distinguishing permissible from unconstitutional tax exemptions and credits. Dan Coenen and Walter Hellerstein created an analytical framework for

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[40] *Id.* at 406 (quoting Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 331 (1977)).

[41] See, e.g., Westinghouse, 466 U.S. 388, 403 (1984); Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 329 (1977).

[42] Edward A. Zelinsky, *supra* note 3, at 36.

[43] *See id.*

[44] *See id.* at 33-35.

[45] *See* Enrich, *supra* note 3, at 461. Enrich has argued it would be a "shocking development" for some state tax policies to come under Commerce Clause scrutiny. *See id.* at 459.

the Court's tax incentive decisions that relies on in-state favoritism and coercion as deciding factors.[46] Similarly, Philip Tatarowicz and Rebecca Mims-Velarde developed a series of six questions for classifying tax exemptions and credits, and suggested invalidating only those that seek to benefit local interests by imposing burdens on their out-of-state competitors.[47]

The Rationale

Although DaimlerChrysler clearly highlighted these scholarly concerns for the Sixth Circuit,[48] the *Cuno* court largely sidestepped that debate. Instead, the *Cuno* court followed the Supreme Court's case-by-case lead, looking only to whether the challenged provisions offered "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter."[49]

Looking first at the investment tax credit, the court acknowledged that the credit was equally available to both in-state and out-of-state businesses.[50] Despite this equal availability, however, the court noted that corporations would be subject to unequal tax treatment based on in-state or out-of-state investment decisions.[51] Someone paying Ohio taxes would receive a credit against Ohio taxes due in exchange for further Ohio investment, while a similar Ohio taxpayer that chose to invest in Michigan instead would not. Comparing the tax investment credit to the tax provisions considered in the *Boston Stock Exchange*, *Maryland v. Louisiana*, and *Westinghouse* decisions, the Sixth Circuit found the tax credit used the state's power to tax to encourage the development of local business. Because "the economic effect of the Ohio investment tax [wa]s to

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[46] *See* Coenen & Hellerstein, *supra* note 3, at 804.

[47] *See* Philip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 VAND. L. REV. 879, 886 (1986).

[48] *See* Final Brief of Appellee DaimlerChrysler Corp., *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738 (6th Cir. 2004).

[49] Cuno v. DaimlerChrysler, Inc., 386 F.3d 738, 743 (6th Cir. 2004).

[50] *See id.*

[51] *See id.*

encourage further investment in-state at the expense of development in other states,"[52] the court held the tax investment credit unconstitutional under the Commerce Clause.

Turning to the property tax exemption, the court's initial analysis focused on the eligibility conditions placed on the exemption. The plaintiffs argued that the requirement to "agree to maintain a specified level of employment and investment" in Ohio resulted in preferential tax treatment for the taxpayer who agrees to the conditions as compared to the taxpayer who chooses to remain free to hire and invest elsewhere.[53] The court rejected this argument, however, stating that "conditional exemptions raise no constitutional issues when the conditions for obtaining the favorable tax treatment are related to the use or location of the property itself."[54] The court found persuasive the fact that the statute imposed no specific monetary requirement, no job creation requirement, no restriction on the persons employed or served, and no inducement to engage in another form of business independent of the newly acquired property – all conditions that court suggested might independently burden interstate commerce. Without these characteristics, the court concluded, the property tax exemption did not resemble others previously held unconstitutional.

The court further dismissed the argument that the exemption created a discriminatory economic effect. Here, the court identified the "fundamental differences" between tax credits and exemptions: "[u]nlike an investment tax credit that reduces pre-existing income tax liability, the personal property tax exemption does not reduce any existing property tax liability."[55] Thus, the court concluded, a taxpayer's decision not to invest in Ohio simply means that the taxpayer will not be subject to the property tax at all, just like the taxpayer for whom the property tax has been

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[52] *Id.* at 745.
[53] *Id.*
[54] *Id.*
[55] Cuno, 386 F.3d at 747.

waived. Recognizing that "any discriminatory treatment between a company that invests in Ohio and one that invests out-of-state cannot be attributed [to] the Ohio tax regime," the court held the property tax exemption constitutional.[56]

The *Cuno* court rejected the defendants' attempt to apply a categorical framework to the Supreme Court decisions, noting that the Supreme Court itself had not yet adopted such an approach. Moreover, the court dismissed the defendants' comparison of the investment tax credit to a constitutionally permissible direct subsidy. While the court acknowledged that a direct subsidy would have the same economic effect as the tax credit — an effect the court concluded to be impermissible — the court nonetheless distinguished the tax credit as constitutionally infirm due to the "fact that the tax credit involves state regulation of interstate commerce through its power to tax."[57]

Just as they have done with the Supreme Court's cases in this area, scholars could parse the Sixth Circuit's rhetoric in *Cuno* to divine yet another set of rules for distinguishing good tax credits and exemptions from bad. Yet the *Cuno* court explicitly declined to offer such guidance. Ultimately, the court's stated reason for continuing down the analytical slippery slope was that the Supreme Court has provided no basis for arresting that slide.

The Implications

While the relationship between the dormant Commerce Clause and state tax policy will strike many followers of Supreme Court jurisprudence as a dry and esoteric issue, the *Cuno* decision could have far-reaching impact. Ohio is not the only state with a potential *Cuno*-style problem. Most states have enacted various tax incentive provisions designed to encourage economic development. Many state legislatures have demonstrated their willingness further to provide direct subsidization on a case-by-case

[56] *Id.* at 747-48.
[57] *Id.* at 746.

basis. Some of these other states face litigation similar to the *Cuno* case. The Sixth Circuit's opinion calls into question existing tax statutes and economic development policies of many if not most states, as well as the future of state tax policy, and raises important questions about the role of the courts in guiding state tax decisionmaking.

A. What Does *Cuno* Mean for the States?

In order to appreciate fully the implications of the *Cuno* decision, it is necessary to understand just how broadly the Sixth Circuit's opinion on the Ohio investment tax credit potentially sweeps. By striking down the Ohio investment tax credit based on its discriminatory economic effect of favoring local investment at the expense of out-of-state investment, the Sixth Circuit followed a line of reasoning that lacks reasoned limitation. Many if not most state tax policies aimed at encouraging economic development by their very purpose entail favoring local over out-of-state investment. Indeed, existing antidiscrimination analysis suggests that even the Ohio property tax exemption should fall due to its effect of giving local property investment a break on taxes that other states are known to impose, notwithstanding the Sixth Circuit's conclusion to the contrary. Many would argue that, since most state taxes are imposed only on in-state activity, any reduction in state taxes would, in some sense, discriminate against out-of-state activity.[58]

For example, if State A were to lower its overall corporate franchise tax rate from 6% to 4% in order to encourage in-state businesses to expand their State A businesses and to woo corporations from State B (with an existing franchise tax rate of 6%), this rate reduction would have the same economic effect for a given taxpayer as offering a more targeted tax incentive. Certainly, such a rate reduction would be considered a use of the state's taxing power to encourage local business activity. Applying the *Cuno* court's analysis, such a rate reduction could be

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[58] *See* Zelinsky, *supra* note 3, at 36.

unconstitutional as applied to those businesses already located in State A, though permissible with regard to corporations lacking State A presence.

Another important consideration is whether the court's distinction between tax incentives and direct tax subsidies is really a distinction at all.[59] The *Cuno* court itself acknowledged that the two devices had the same ultimate effect, yet the tax incentive was deemed unconstitutional because it stemmed from the state's power to tax. While it is true one of the original purposes for the Commerce Clause was to eliminate the discriminatory taxation between and among the states,[60] it does not logically follow that practices that produce the same discriminatory results are acceptable as long as the state's taxing power is not implicated. And the *Cuno* court's emphasis on the discriminatory *effect* of the state tax incentive suggests that just such a distinction between tax and non-tax is not possible.[61]

Supporters of the Sixth Circuit's decision dismiss the importance of doctrinal clarity and contend that the courts can address these questions on a case-by-case basis.[62] Admittedly, it seems unimaginable that the courts would ever go so far as to invalidate a general reduction in tax rates as a violation of the Commerce Clause.[63] Left unanswered, however, is the question of how states should distinguish between permissible state tax competition and unconstitutional discriminatory tax schemes in developing coherent tax systems.

The *Cuno* decision thus leaves open the possibility that a whole host of state tax credits, deductions, and programs intended to encourage economic development are

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[59] *See id.*; Zelinsky, *supra* note 58, at 35.

[60] *See* Rogers, *supra* note 19, at 105.

[61] *See* Enrich, *supra* note 3, at 459 ("[C]ash subsidies . . . surely distort economic decisions in precisely the same way as tax benefits.").

[62] *See id.* at 462 (quoting West Lynn Creamery, Inc. v. Healey, 512 U.S. 186, 201 (1994)).

[63] *See id.* at 459 ("As the Court has emphasized, '[t]he simple fact is that the appropriate level or rate of taxation is essentially a matter for legislative, and not judicial, resolution.'").

constitutionally suspect. Given the prevalence of state tax incentives,[64] many states are left wondering what to do. Most states have remained steadfast, continuing to offer tax incentives.[65] Other states have braced themselves for litigation, defending against constitutional challenges of tax incentives of their own.[66]

Minnesota is one such state. In 2003, the Minnesota legislature enacted two programs — the Job Opportunity Building Zone (JOBZ) and the Biotechnology and Health Sciences Industry Zone (Biotech Zone) — to promote economic development through tax incentives. The JOBZ program designates ten areas within the state as "job opportunity zones"; this designation allows businesses within the zones to receive partial property tax exemptions, qualified individual tax exemptions on investment income, sales tax exemptions on qualified purchases, and corporate franchise tax exemptions based on the percentage of business operations in the zone. The Biotech Zone program is similar to the JOBZ program, but is targeted at corporations that research, develop, or manufacture biotechnology products. To qualify for these business incentives, a business must operate or relocate in a zone and must increase its employment or make certain capital investments. Plaintiffs Alec G. Olson and Butterworth LP have brought suit alleging the programs violate the Commerce Clause and other provisions of the Minnesota and United State Constitutions.[67]

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[64] *See* Walter Hellerstein, *Commerce Clause Restraints on State Tax Incentives*, 82 MINN. L. REV. 413, 421-23 (1997); Young, *supra* note 12.

[65] *See, e.g.*, *Tax Incentives Will Be Tested by High Court*, LINCOLN JOURNAL STAR, Sept. 28, 2005, at B1; Tom Ramstack, *Justices to Mull Business Tax Lures*, WASH. TIMES, Sept. 28, 2005; Kentucky Business Incentives, http://www.thinkkentucky.com/kyedc/kybizince.asp (last visited Nov. 6, 2005). As Clay Gillette has noted, "[N]o state, aware of the incentive programs offered by other jurisdictions, can escape from the cycle . . . for fear that doing so will place it at a competitive disadvantage in the search for economic development." Gillette, *supra* note 3, at 479.

[66] *See* Young, *supra* note 12 ("Unsurprisingly, other cases attempting to take advantage of this novel interpretation are already pending (with suits filed in Minnesota and Wisconsin, with additional cases expected in Nebraska, Oklahoma, and North Carolina.)").

[67] *See* Jennifer Carr & Cara Griffith, *Litigation and Tax Incentives After the Downfall of Ohio's ITC*, STATE TAX NOTES, 367-68 (May 2, 2005).

North Carolina is in a similar position. In 2004, the North Carolina General Assembly passed legislation to provide tax incentives and subsidies to computer manufacturers that locate facilities within North Carolina.[68] While the bill did not specifically reference any computer manufacturers, it was well-understood the legislation was designed to encourage Dell to locate a facility in the Winston-Salem area. Under the legislation, Dell may claim a 100% credit against corporate income or corporate franchise tax and may claim refunds of sales and use taxes paid on building the facility. The legislation also established lenient eligibility requirements for the incentives and grants, with no wage requirement and no requirement that certain employment levels be sustained. The total state incentive package offered to Dell was estimated at $242 million; Dell will receive an additional $37 million in incentives from Winston-Salem and Forsyth County.[69] In June 2005, Robert Orr, a former North Carolina Supreme Court justice, brought suit on behalf of the N.C. Institute for Constitutional Law, claiming the incentives violate the Commerce Clause and Equal Protection Clause of the United States Constitution, as well as various North Carolina constitutional provisions.[70]

In both the Minnesota and North Carolina cases, the plaintiffs have cited the Sixth Circuit's *Cuno* decision as supporting their claims. The litigation in Minnesota and North Carolina is representative of the exposure to litigation many other states face as a result of the *Cuno* decision.[71] The likelihood of nationwide litigation on state tax incentive issues serves to underscore the impact and the significance of the *Cuno* decision.

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[68] *Suit Filed in North Carolina to Enjoin Incentives Offered to Computer Manufacturing Facility*, 66 STATE TAX REVIEW (CCH) 1 (July 6, 2005) [hereinafter *Suit Filed*].

[69] Paul B. Johnson, *Dell Opens This Week*, HIGH POINT ENTERPRISE, October 4, 2005.

[70] *Dell Deal Challenge Merits Legal Answer*, GREENSBORO NEWS & RECORD, Oct. 14, 2005, at A12; *Suit Filed*, *supra* note 68.

[71] *See* Jennifer Carr & Cara Griffith, *supra* note 67, at 369.

In the end, rather than supplying the principled guidance states need to conform their tax policies to constitutional requirements, the Sixth Circuit has instead merely continued the controversy and confusion. So while it is true the Supreme Court has acknowledged that states are free to compete with one another for a share of interstate commerce, the antidiscrimination principle developed by the Court and pursued by the Sixth Circuit in *Cuno* threatens to restrain variation and innovation severely in the area of state taxation.[72]

B. Who Should Be Able To Decide?

Though the states and taxpayers are crying out for guidance, is it right to criticize the courts for declining to do more than follow the existing case-by-case approach? The courts have described their role in this context as "mak[ing] the delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual States in exercising their taxing powers."[73] The case-by-case model employed by the courts, factoring in "the unique characteristics of the statute at issue and the particular circumstances,"[74] may create few principles on which states can rely. But at a time when "judicial restraint" has become something of a mantra, it is perhaps unrealistic or even undesirable to ask the courts to provide a broad but arbitrary test for evaluating the discriminatory effect of a panoply of state tax exemptions, credits, and deductions. Though scholars have long criticized the lack of guiding principles in the Court's case-by-case model for addressing the relationship between tax incentives and the Commerce Clause, the Court's jurisprudence to date has not intruded that far into the realm of state tax competition.

Cuno arguably breaks new ground in pushing the courts further toward compelling tax uniformity among the states; but perhaps that is less due to the Court's

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[72] *See* Enrich, *supra* note 3, at 466.
[73] Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 329 (1977).
[74] *Id.*

interpretation of the Commerce Clause than the lower courts' willingness to entertain a more aggressive strain of lawsuits. One distinguishing factor between *Cuno* and the cases before it is the identity of the plaintiffs. In all of the cases relied upon by the *Cuno* court, the plaintiffs were states, businesses, or both – *i.e.*, parties with a broader interest in not pushing the Court's antidiscrimination analysis too far, lest they lose their own ability to participate in and benefit from state tax competition. It is in these parties' interests to pursue a careful balance between national and local interests in Commerce Clause jurisprudence.

By contrast, the *Cuno* plaintiffs have no reason to pursue or even respect such balance. Unlike the Boston Stock Exchange or Westinghouse Electric or the gas producers who brought suit in *Maryland v. Louisiana*, the *Cuno* plaintiffs do not allege that a state is using a particular tax credit or exemption to favor a local competitor's business interests over their own or otherwise to discriminate against them personally. Instead, the *Cuno* plaintiffs are simply taxpayers who disagree with the economic development policies pursued by their government officials. While some taxpayer suits are motivated by idealistic dedication to lofty constitutional goals such as free speech or equal protection, the plaintiffs in *Cuno* and similar litigation are hardly motivated by similar allegiance to Commerce Clause principles. State tax incentives for economic development have been the subject of much policy debate. The *Cuno* case merely reflects the underlying policy disagreement between those like the *Cuno* plaintiffs who see state tax incentives as an improper allocation of state funds and a drain on state tax revenues and the states that remain adamant that the incentives are needed to encourage economic development. The Commerce Clause is merely one mechanism by which the *Cuno* plaintiffs hope that the courts will mandate the policy outcome that incentive opponents have been unable to achieve legislatively.

Notwithstanding the policy debate, state legislatures have continued to employ state tax incentives as a

mechanism for economic development. Opponents of state tax incentives argue that the very nature of state tax competition prevents state legislatures from ending the economic war, even though doing so would be in their own best interests; and they argue that a federal solution is required. They may be right. Federal involvement does not necessarily entail a judicial response.

Many have urged Congress to take action to end state tax competition.[75] With that goal in mind, U.S. Representative David Minge of Minnesota has endeavored to persuade Congress to impose an excise tax on businesses benefiting from state tax incentive programs and prohibit states from using federal funds in connection with such activities.[76] By contrast, in response to the Cuno decision, however, state governments have lobbied Congress to enact the Economic Development Act of 2005, which purports to preserve the ability of the states to pursue state tax incentive programs.[77] It is not at all clear that congressional action will be a panacea, however. As Walter Hellerstein argues, the current proposed federal legislation appears to do little more than codify the muddled Supreme Court precedent.[78] Such "guidance" could merely shift the litigation focus from constitutional attacks to statutory attacks.

Regardless, the Court is ill-equipped to wade through competing economic studies of state tax incentives to develop a test for distinguishing the good from the bad. Edward Zelinsky has advocated returning the issue of state

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[75] *See* Rogers, *supra* note 60, at 138; Burstein & Rolnick, *supra* note 4, at 1900 ("[I]t is now time for Congress to exercise its Commerce Clause power to end another economic war among the states."). *But see* Gillette, *supra* note 3, at 478 ("It . . . does not follow that federal intervention to save states from themselves is warranted.").

[76] *See, e.g., Minge Testimony at W&M Oversight Hearing on Tax Code and Economy*, 2000 TAX NOTES TODAY 188-22 (Sept. 27, 2000); *Minge Testimony at House Budget Hearing on Unnecessary Business Subsidies*, 1999 TAX NOTES TODAY 127 (July 2, 1999); *Minge Bill Would Tax Companies' State, Local Relocation Subsidies*, 1999 TAX NOTES TODAY 58 (March 26, 1999); *Minge Bill, H.R. 3044, Would Tax State, Local Subsidies for Businesses*, 1997 TAX NOTES TODAY 228 (Nov. 26, 1997).

[77] S. 1106, 110th Cong. (2005).

[78] *See id.*; Walter Hellerstein, Cuno *and Congress: An Analysis of Proposed Legislation Authorizing State Economic Development Incentives*, 4 GEO. J.L. & PUB. POL'Y __ (2006).

tax incentives to the political branches,[79] and Brannon Denning correspondingly urges the Court toward a minimalist resolution of the *Cuno* case.[80] Frustrating though such an outcome would be to the *Cuno* plaintiffs, standing doctrine may represent the best means by which the Court could overturn the Sixth Circuit, avoid far-reaching economic policy implications, and remove the federal judiciary from the debate.[81]

C. A Mountain or a Molehill?

Taking the federal judiciary out of the equation would do nothing to resolve the policy debate over state tax incentives, however. Moreover, overturning the *Cuno* decision could remove the primary incentive for prompt congressional action and simply return the matter to the states. How concerned should we be with that outcome?

It is important to consider whether state tax incentives represent good economic policy. Economists have collected an abundance of evidence that many if not most state tax incentive programs are economically inefficient and represent bad economic policy.[82] Prominent commentators describe state tax competition as a "race to the bottom" that leaves all states with less tax revenue for roads, schools, police and fire protection, and all manner of public goods, including economic development initiatives.[83] As one scholar has concluded,

> There is substantial evidence that [state tax] incentives are not a cost-effective means of stimulating investment and job creation.

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[79] *See, e.g.*, Edward A. Zelinsky, *Ohio Incentives Decision Revisited*, 37 STATE TAX NOTES 859 (Sept. 19, 2005) ("There is much to be said for . . . federal legislation producing the kind of targeted tax breaks challenged in Cuno.").

[80] *See* Brannon P. Denning, Cuno *and the Court: The Case for Minimalism*, 4 GEO. J.L. & PUB. POL'Y __ (2006).

[81] In granting certiorari, the Court asked the parties to brief the issue of standing. The Court may dismiss the case on standing grounds without deciding the constitutionality of the tax investment credit.

[82] *See, e.g.*, Peters & Fisher, *supra* note 4.

[83] *See* Enrich, *supra* note 3, at 466-67; Rogers, *supra* note 4, at 107; Burstein & Rolnick, *supra* note 4, at 1896-98.

> Eliminating them could improve state tax and economic policy by freeing up billions of dollars that could be used more productively for some combination of general tax cuts, worker education and training, and infrastructure improvements.[84]

To varying degrees, other experts have defended the economic wisdom of at least some state tax incentive programs, depending upon how they are structured.[85] Thus viewed, tax competition among the states is not automatically a bad thing. State governments remain adamant in defending their prerogative of making their own tax policy decisions without federal judicial interference.[86] State innovation and experimentation are invaluable traits of our federalist system; and placing limitations on the use of state tax incentives effectively eliminates one area within which states could experiment and innovate.[87]

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[84] David Brunori, *The Politics of State Taxation: Helping States Hurt Themselves*, 36 STATE TAX NOTES 752 (June 6, 2005), *quoted in* Zelinsky, *supra* note 79.

[85] The strength and scope of such defenses varies greatly. For example, Michael Mazerov is strongly critical of most existing tax incentive programs, but notes that economists would support the granting of economic development incentives in the form of sales tax exemptions for business purchases. *See* Michael Mazerov, *The Ohio Investment Credit Decision: Modest but Helpful 'Arms Control' in the 'Economic War Between the States'*, 35 STATE TAX NOTES 849, 854 (March 21, 2005). Mazerov also acknowledges that the public visibility of property tax abatements and direct subsidies makes these incentives at least preferable to more private tax credits. *See id.* By comparison, Arthur Rolnick and Mel Burstein argue principally against providing direct subsidies and preferential tax treatment to individual businesses. *See* Rolnick & Burstein, *supra* note 4. Still others tout the economic merits of a wider range of state tax incentive programs. *See* Kevin Thompson, *Coalition Forms to Promote Federal Protection of State Tax Incentives*, BUDGET & TAX NEWS, March 1, 2005, available at http://www.heartland.org/Article.cfm?artId=16549 ("Some economists argue state tax incentives encourage job creation and investment that otherwise would not occur . . . .").

[86] *See, e.g.*, Adam Bruns, *Missouri Needs Business Climate Reform, and the State's New Governor Aims to Deliver It*, SITE SELECTION, July 2005, *available at* http://www.siteselection.com/features/2005/jul/mo ("[Missouri's incentive program] Quality Jobs is an example of a program that would meet any sort of court challenge. . . . If there were any sort of court-created problem, we're going to respond to that quickly.").

[87] *See* Enrich, *supra* note 3, at 459.

Even if the Court upholds the Sixth Circuit in *Cuno*, the policy debate will continue, albeit in a slightly different form. It is unrealistic to expect that the states will give up competing for new business; and as it stands, the *Cuno* decision does not reject all state economic competition. At a minimum, the Sixth Circuit's decision leaves open the opportunity for states to use direct subsidies instead of tax incentives to lure new business development. Indeed, Ohio is already adjusting its economic development activities in that direction in response to *Cuno*.[88]

While some state tax incentive programs may be economically unwise, overturning the Sixth Circuit's opinion in *Cuno* and returning the matter to the states may not lead to state economic Armageddon. Upholding the Sixth Circuit's opinion in *Cuno* may only cause states to adjust their policies to a new constitutional reality and shift the debate from tax incentives to direct expenditures. Either way, it seems as plausible as not that the *Cuno* case could have very little practical impact, regardless of how the Court resolves it, notwithstanding the dire predictions of each side.

Conclusion

Ultimately, the *Cuno* decision presents more questions than it answers. With the Supreme Court granting certiorari, it is possible that at least some answers will come. It is equally conceivable, and maybe preferable, that the Supreme Court will sidestep the heart of the issue, resolve the case without reaching the merits, and leave the matter of state tax incentives to the political branches. Either way, it seems certain that those who attended the conference in Minneapolis and who contributed to the essays to follow can look forward to the discussion to come.

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[88] *See* Edward A. Zelinsky, *Ohio Incentives Decision Revisited*, 37 STATE TAX NOTES 859 (Sept. 19, 2005) (discussing congressional testimony of Ohio Lt. Gov. Bruce Johnson).