The Economic Development Act of 2005
A Response to *Cuno v. DaimlerChrysler*

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Agenda

- Background - - Cuno v. DaimlerChrysler
- Governing Federal Law
- Causes that Precipitated the Cuno Controversy
- Available Options – Advantages/Disadvantages
  - States and Taxpayers: Mutuality of Interests
  - Dangers in Congressional Authorization
- Technical and Political Constraints
- Proposed Economic Development Act of 2005
  - *S. 1066 and H.R. 2471*

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Cuno v. DaimlerChrysler

- Ohio's Investment Tax Credit (ITC) violates the dormant Commerce Clause because it unconstitutionally discriminates against interstate commerce.
- The Sixth Circuit Court of Appeals held Ohio's conditional personal property tax incentive was valid.
- Court determined a credit for pre-existing tax liability is unconstitutional because of its "coercive" power, but an exemption to avoid tax on new property is not "coercive" and does not discriminate against interstate commerce.

Governing Federal Law

- Article I, Section 8, Clause 3 of the U.S. Constitution gives Congress the power to "*regulate* Commerce with foreign Nations, and among the several States, and with Indian Tribes."
- In addition to giving Congress the power to regulate commerce, the Commerce Clause has been interpreted to have a "negative implication" known as the "dormant Commerce Clause."
- When Congress affirmatively addresses an issue (e.g., McCarran-Ferguson Act, Pub. L. 86-272), the judiciary is no longer responsible to determine if state action implicates the dormant Commerce Clause.

Causes that Precipitated the Cuno Controversy

- Congress has not given taxpayers, states nor the courts any guidance
- Conflicting U.S. Supreme Court guidance (e.g., Boston Stock Exchange, Westinghouse Electric)
  - Tax incentives cannot interfere with tax-neutral decisions, but
  - States can structure their tax systems to encourage the growth and development of intrastate commerce and industry.
- Economic theory arguments of corporate welfare and race-to-the bottom economics
- Personal philosophies and proposed judicial standards advanced by various commentators
  - Application of proposed standards results in dramatic differences in the type of tax incentives that would be permissible

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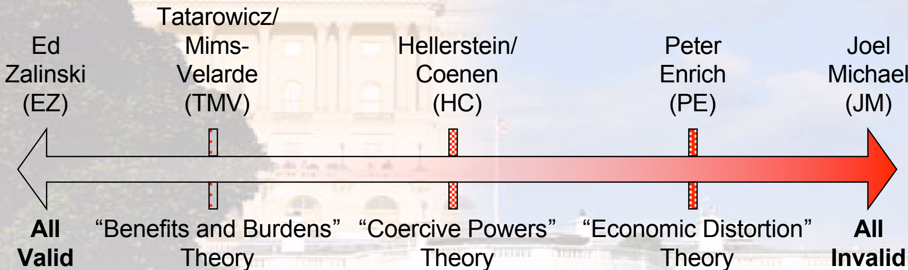
Causes that Precipitated the Cuno Controversy



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Causes that Precipitated the Cuno Controversy

Permissible ("P") Or Impermissible ("I") Tax Incentives

Function/Purpose/Tax	TMV Approach*	HC Approach	PE Approach
Apportionment Formula**	P	P	P**
Non-Tax Subsidies**	P	P	I***
Apportioned Incentives	I	I	I
Income Based Taxes			
A. Credits	P	I	I
B. Deductions	P	P	I
C. Relocation Incentive	P	P	I
D. Expansi on Incentives	P	I	I

* If does not "burden" out-of state activity
** Not subject to CAT's discrimination prong. Impermissible if unduly weights sales factor
*** If approach extended beyond tax measures

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Causes that Precipitated the Cuno Controversy

Permissible ("P") Or Impermissible ("I") Tax Incentives

Function/Purpose/Tax	TMV Approach*	HC Approach	PE Approach
Sales and Use Taxes	P	P**	P
Property Taxes	P	P**	I
Gross Receipts Taxes	P	P***	I
Value Added Taxes			I
A. Credit Method	P	P	I
B. Additive Method	P	I***	I
C. Subtractive Method	P	I***	I

* If does not "burden" out-of-state activities
** If does not violate "independent activities" standard
*** Unclear. Appears permissible if viewed as a transactional tax; contra, if not and taxpayer is already subject to the tax.

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Available Options – Advantages/Disadvantages

- Look to U.S. Supreme Court?
  - Petition for writ of certiorari filed
  - Timing and potential outcome unknown
- Seek Congressional affirmation?
  - A "real" option?
    - Virtually unprecedented (tax based) mutuality of interests suggests "yes"
    - Beware: Permissible tax incentives limit Commerce Clause anti-discrimination safeguards

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States and Taxpayers – Mutuality of Interests

- Legally protect the states and taxpayers' reliance interests
  - Preserve all carrybacks and carryforwards
- Respect fiscal federalism in this area
  - Affirm states' rights to offer tax incentives within the Court's current guidelines
- Stem the tide of future cases inconsistent with these goals
- Provide certainty to all parties involved in an expedient manner

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Dangers to Congressional Authorization

- The Commerce Clause safeguards multistate taxpayers from prohibited tariffs and other burdens not imposed on intrastate commerce
- Authorized tax incentives could be used to "camouflage" impermissible discrimination
  - This is not a new problem
  - It is inherent when creating an exclusion within an otherwise prohibited area
  - The broader the carve out for exclusions, the more opportunities exist to camouflage potentially impermissible tax incentives

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Illustration of Problem

- Example: Sales and Use Tax
  - Situation One. Assume State A imposes a sales/use tax on prefabricated housing. Assume further that if built in State A only cost of materials is subject to State A's sales tax; however, if built in State B, cost of materials plus labor is included in base of use tax.
    - Use tax impermissibly discriminates
      - See, e.g., Halliburton Oil Well Cementing Co. v. Reily
  - Situation Two. Assume sales and use tax bases are identical, but State A offers a "tax incentive" for in-state property and/or labor investments
    - Non-discriminatory assuming definition of tax incentive does not, among other things, negate beneficial impact of the compensatory tax doctrine
      - See, e.g., Maryland v. Louisiana

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Congressional Solution – Technical and Political Constraints

- Political opposition increases as the Congressional authorization becomes more broad
- Other federal laws and more restrictive state laws that protect multistate taxpayers cannot be superseded
- Leave historical judicial protection in place to combat newly developed forms of disparate tax treatment that do not meet the Congressionally approved definition of a tax incentive
- A "legislative" model similar to the IRC is desired by the business community and would avoid many of the issues raised by using a "judicial" or "administrative" model
- The Congressional authorization should have retroactive effect
- Assume parties will have one opportunity for Congressional assistance
  - Incorporate a severability clause to prevent failure of the entire Act

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Proposed Economic Development Act of 2005

S. 1066 and H.R. 2471

- Scope of Authorization
- Tax Incentives not subject to protection (Limitations)
  - No Inference Rule
- Definitions
  - Rule of Construction
- Severability Clause
- Effective date and retroactive application

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Overview – Economic Development Act of 2005

Section 2 of the Act provides*:

Congress hereby exercises its power … to regulate commerce … by authorizing any "*State*" to provide to any '*person'* for '*economic development purposes'* '*tax incentives'* that otherwise would be the cause or source of discrimination against interstate commerce under the Commerce Clause …, except as otherwise provide by law.

* For the reader's convenience, words and phrases defined in Section 4, Definitions, have been italicized and place in quotation marks.

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Overview – Authorization

- The Act does not prohibit any tax incentive. It simply authorizes some of the most common tax incentives offered by the states today
- U.S. Supreme Court's Commerce Clause jurisprudence still governs any tax incentive not authorized by the Act
- Section 2 of the Act limits Congressional authorization of tax incentives that are subject to judicial review under the discrimination prong of the four-part test established in Complete Auto Transit, Inc. v. Brady.
  - Activity has substantial nexus with the taxing State
  - Fairly apportioned
  - Not discriminatory against interstate commerce
  - Fairly related to services provided by the State

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Overview – Authorization cont'd

- The Act does not supersede, override or in any other way take priority over other Congressional laws prohibiting, e.g.,:
  - State tax discrimination against railroads
  - Out-of-state purchases of electricity
  - National banks, federal savings and loan associations
  - Air and motor carriers
- This provision also does not legislatively reverse U.S. Supreme Court decisions interpreting other Federal laws that struck down tax structures even if those tax structures might be construed as authorized tax incentives under this Act.

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Limitations – Section 3 of the Act

- Section 3(a) of the Act details seven limitations that are not authorized State tax incentives as provided by Section 2.
- Each limitation contained in Section 3(a) of the Act is based on U.S. Supreme Court decisions that struck down a State tax provision as discriminatory under the dormant Commerce Clause.
- Including the seven limitations narrows the tax incentives authorized by Congress through this federal legislation.
- Eliminating any of the limitations could be interpreted as Congress taking action to legislatively reverse prior U.S. Supreme Court decisions governing the Commerce Clause.

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Limitations – Subsection 3(a)(1)

The Act does not apply to any State tax incentive that "is dependent upon State or country of incorporation, commercial domicile or residence of an individual".

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Limitations – Subsection 3(a)(1) cont'd

- Corporations incorporated domestically can manipulate the par value of their stock to reduce franchise tax liability.
- Corporations not incorporated domestically must also include items that are based on GAAP and cannot be manipulated in determining franchise tax liability.

Domestic Corporation

Par Value of Stock	$ X
* Franchise Tax Rate	1.0%
Franchise Tax Liab.	$0.1*X

** X can be manipulated by the taxpayer in order to reduce its Alabama franchise tax liability.

Foreign Corporation

Par Value of Stock	$ X
+ LT Debt	$ Y
+ Surplus	$ Z
* AL Appt. %	A %
* Franchise Tax Rate	0.3%
Franchise Tax Liab.	$ M

** Although X can be manipulated by the taxpayer, Y and Z cannot because they are based on GAAP.

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Limitations – Subsection 3(a)(1) cont'd

- Section 3(a)(1) ensures that a tax incentive is not limited to benefit only in-state residents or business entities incorporated or commercially domiciled in the state.
- Although other Federal limitations exist (e.g. Equal Protection Clause and the Privileges and Immunities Clause), this section incorporates existing U.S. Supreme Court decisions that created additional safeguards.

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Limitations – Subsection 3(a)(2)

The Act does not apply to any State tax incentive that "requires the recipient of the tax incentive to acquire, lease, license, use or provide services to *'property'* produced, manufactured, generated, assembled, developed, fabricated, or created in the State".

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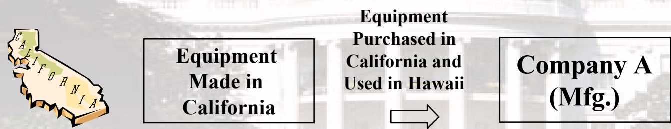
Limitations – Subsection 3(a)(2) cont'd

- Hawaii's exemption for sales/use tax paid on manufacturing equipment is dependent on that equipment being made in Hawaii.

Purchase of Manufacturing Equipment *Exempt* from Sales Tax in Hawaii

Purchase of Manufacturing Equipment *Subject to* Use Tax in Hawaii



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Limitations – Subsection 3(a)(3)

The Act does not apply to any State tax incentive that "is reduced or eliminated as a direct result of an increase in out-of-State activity by the recipient of the tax incentive".

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Limitations – Subsection 3(a)(3) cont'd

- New York's franchise tax credit for accumulated DISC income is reduced if the DISC's non-New York gross receipts increase.

New York DISC Credit

Acc. DISC Income	$ X
* New York Appt. %	Y %
* NY Tax Rate	5 %
* NY Export Ratio	Z %
Multiply by 70%	70%
Franchise Tax Credit	$ M

New York Export Ratio

$$Z = \frac{\text{DISC's Receipts shipped from NY}}{\text{DISC's Total Gross Receipts}}$$

- Increase in DISC's Total Gross Receipts ***decreases*** NY Franchise Tax Credit.
- Increase in DISC's NY Receipts ***increases*** NY Franchise Tax Credit

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Limitations – Subsection 3(a)(4)

The Act does not apply to any State tax incentive that "is reduced or eliminated as a result of an increase in out-of-State activity by a person other then the recipient of the tax incentive or as a result of such other person not having a taxable presence in the State".

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Limitations – Subsection 3(a)(4) cont'd

- The Intangibles tax credit/deduction is reduced or eliminated because of an increase in out-of-state activity by a person (Corp. A) other than the taxpayer.
- Any increase in Corp. A's out-of-state activity reduces its North Carolina apportionment factor which in turn reduces the credit/deduction against the Intangibles tax.

North Carolina Intangibles Tax		Intangibles Tax Credit/Deduction
FMV of Corp. A Stock	$ X	Y = Corporation A's North Carolina Apportionment Factor
* Tax Rate	0.25%	
- Credit	($X * 0.25%) * Y	
Tax Liab.	($X * 0.25%) * (1 – Y)	

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Limitations – Subsection 3(a)(5)

The Act does not apply to any State tax incentive that "results in loss of a '*compensating tax system*' because the tax on interstate commerce exceeds the tax on intrastate commerce".

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Limitations – Subsection 3(a)(5) cont'd

- In order to justify a charge on interstate commerce as a compensatory tax, a State must:
  - Identify the intrastate tax burden for which it is compensating, and
  - Tax the interstate activity at a rate that approximates, but does not exceed, the tax on intrastate commerce.
- This section is not limited only to sales and use taxes. By including a more broad reference to any type of compensating tax system, this limitation was designed to avoid the potential of controversy or litigation.
- In addition, the Court has expanded and contracted its definition of the compensatory tax doctrine over the years. By including broader language, this section will also contract and expand with the Court's jurisprudence.

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Limitations – Subsection 3(a)(6)

The Act does not apply to any State tax incentive that "requires that other taxing jurisdictions offer reciprocal tax benefits".

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Limitations – Subsection 3(a)(7)

The Act does not apply to any State tax incentive that "requires that a tax incentive earned with respect to one tax can **only** be used to reduce a tax burden for or provide a '*tax benefit'* against any other tax that is not '*imposed on apportioned interstate activities*'".

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Limitations – Subsection 3(a)(7) cont'd

- Non-Louisiana consumer/taxpayer cannot use excise tax liability as a credit unless it is subject to another Louisiana tax, i.e. Severance tax.

Louisiana Consumer		Maryland Consumer	
Excise Tax per 1,000 ft^3	$ .07	Excise Tax per 1,000 ft^3	$ .07
* 1,000 ft^3	X	* 1,000 ft^3	X
Excise Tax Liab.	$0.07*X	Excise Tax Liab.	$0.07*X
LA Severance Tax	***$ Y***		
Credit, Excise Tax Paid	***$0.07*X***		
LA Tax Due	***$(Y – 0.07*X)***		

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No Inference Rule – Section 3(b)

Nothing in this section shall be construed to create any inference with respect to the validity or invalidity under the Commerce Clause of the United States Constitution of any tax incentive described in this section.

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Rule of Construction – Section 4(b)

It is the sense of Congress that the authorization provided in section 2 should be construed broadly and the limitations in section 3 should be construed narrowly.

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Severability Clause

If any provision of this Act or the application of any provision of this Act to any person or circumstance is held to be unconstitutional, the remainder of this Act and the application of the provisions of this Act to any person or circumstances shall not be affected by the holding.

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Effective Date

This Act shall apply to any State tax incentive enacted before, on, or after the date of the enactment of this Act

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Effective Date

- Section 6 incorporates a retroactivity provision by applying itself to State tax incentives enacted prior to the enactment date of this Act.
- Tax incentives that are outside the scope of this Act or do not comply with the seven limitations are not covered by the Effective Date.
- The retroactive effective date is intended to reflect a sense of the Congress that consistent with its view of fiscal federalism, a State tax incentive authorized by this Act was always considered by Congress as an appropriate exercise of a State's taxing power.

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QUESTIONS?

APPENDIX A
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PERMISSIBLE INCENTIVE OR
IMPERMISSIBLE DISCRIMINATION?
An Analysis Of Differing Views
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Causes of Judicial Uncertainty

- Most fundamentally … tension between goals of the Commerce Clause (CC) and the liberties promoted by a federalist form of government
  - One goal of CC is to maintain a level playing field between the states
  - One goal of federalism is to promote laboratories of democracy
- Other less fundamental reasons for incomplete guidance
  - Nature of the judicial resolution process
  - Judicial limitations, e.g., standing
  - Financial inducements to challenge
  - Economics of political capital
- Tension is amply illustrated by conflicting guidance provided to date by the U.S. Supreme Court (Court)

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Illustration of Tension Between Permissible and Impermissible Incentives

- The court (e.g., Boston Stock Exchange, Westinghouse Electric) has said that:
  - Tax incentives must not interfere with tax-neutral decision-making, but
  - States are not prevented from structuring their tax systems to encourage the growth and development of intrastate commerce and industry
- Until judicial clarification arrives, this paradox continues to spawn numerous views of what should be a permissible tax incentive vs. impermissible discrimination

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Permissible Incentive Or Impermissible Discrimination?

- Agenda
  - Peter D. Enrich (PE)
    - “Economic Distortion” Theory
  - Wally Hellerstein and Dan T. Coenen (HC)
    - “Coercive Powers” Theory
  - Philip M. Tatarowicz and Rebecca F. Mims-Velarde (TMV)
    - “Benefits And Burdens” Theory
  - Other, e.g.,
    - Edward A. Zelinski (all valid, dormant CC shouldn’t apply)
    - Joel Michael (all invalid, if a “literalist” reading applied)

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Overview Of Different Approaches

- Economic Distortion Theory (PE)
  - No tax incentive is permissible, because it distorts economic decision making in favor of in-state activity
- Coercive Powers Theory (HC)
  - Tax incentive permissible if it does not:
    - Favor in-state over out-of-state activities, and
    - Implicate the “coercive power” of the state

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Overview Of Different Approaches

- Benefits and Burdens Theory (TMV)
  - A tax incentive that relies exclusively on in-state activities in determining an effective tax rate does not have a "negative" (but rather has a "neutral") effect on interstate commerce
    - A tax statute that penalizes an in-state taxpayer if conducting out-of-state activities is impermissible
- Other, e.g.,
  - Edward A. Zelinski (All Valid Theory)
    - Dormant CC should not apply to Complete Auto Transit's (CAT's) "discrimination" prong. This is a tax policy issue best left to Congress.
  - Joel Michael (All Invalid Theory)
    - If court's decisions read literally, all tax incentives would fail

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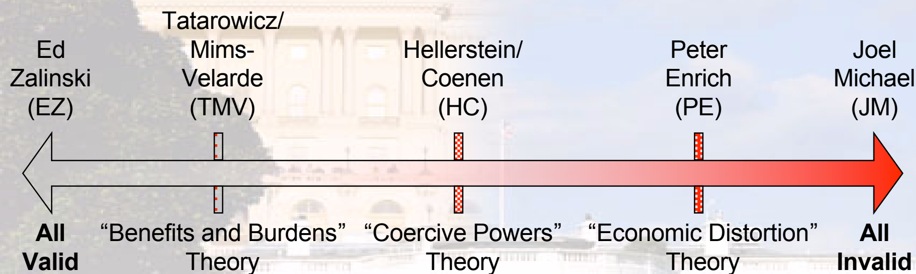
Range of Views

Ed Zalinski (EZ) | Tatarowicz/ Mims-Velarde (TMV) | Hellerstein/ Coenen (HC) | Peter Enrich (PE) | Joel Michael (JM)



All Valid | "Benefits and Burdens" Theory | "Coercive Powers" Theory | "Economic Distortion" Theory | **All Invalid**

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Potential Impact of Differing Views

Permissible ("P") Or Impermissible ("I") Tax Incentives

Function/Purpose/Tax	TMV Approach*	HC Approach	PE Approach
Apportionment Formula**	P	P	P**
Non-Tax Subsidies**	P	P	I***
Apportioned Incentives	I	I	I
Income Based Taxes			
A. Credits	P	I	I
B. Deductions	P	P	I
C. Relocation Incentive	P	P	I
D. Expansion Incentives	P	I	I

* If does not "burden" out-of state activity
** Not subject to CAT's discrimination prong. Impermissible if unduly weights sales factor
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Potential Impact of Differing Views

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PETER D. ENRICH

"Economic Distortion" Theory

The Economic Distortion Theory*

- Does tax provision distort economic decision making in favor of in-state activity? Rationale for principle:
  - "If the CC is to fulfill its function as a foundation for a healthy federalism, it must be liberated from the clutches of a single constituency"
  - CC aims more at preventing states from impeding the free flow of the national economy than protecting multistate business or personal rights.
  - Real danger to CC values comes from dislocations of economic activity, not from disparities in tax burdens
  - An analysis centered on economic distortion avoids the problems of the more familiar disparate treatment approach

* Peter D. Enrich, *Saving The States From Themselves: Commerce Clause Constraints On State Tax Incentives For Business,* 110 Harv. L. Rev 377 (December, 1996)

Observations Of PE Approach

- The "economic distortion" principle goes too far
  - Business location incentives, among other things, would be virtually per se unconstitutional
  - Could easily be extended to implicate state spending and regulatory measures
  - To "work", requires "common sense" boundaries, otherwise challenges what the Court has found beyond CC attack
    - e.g., different states' tax rates, apportionment formulas, exemptions, exclusions, deductions, credits
- The cure does not correct the author's perceived malady
  - Acknowledges that states still would have many remaining tools to attract and retain business investments

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Observations Of PE Approach

- Downplays that states are competing in a global, not solely interstate marketplace
- Concept of distorting economic choices is inherently comparative.
  - Does not define factors that a "neutral baseline" should include
  - Without a defined baseline, leaves no test to use
  - Defining guidelines here is just as inherently arbitrary as it is under other proposed principles

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Observations Of PE Approach

- An overly expansive definition of “discrimination” undermines the states’ historical role as laboratories of democracy and, thus, unduly limits state initiatives and experimentation
  - A pragmatic rather than historical application of the CC better recognizes the reality of global competition and the interests of the nation and properly balances the inherent tension between a federalist form of government and an equal (level) playing field among the states

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WALTER HELLERSTEIN & DAN T. COENEN

“Cohersive Powers” Theory

The Coercive Powers Theory*

- Tax incentive impermissible if it
  - Favors in-state over out-of-state activities, and
  - Implicates the "coercive power" of the state
- Coercive power relates to tax incentives applicable to an "existing" (not "additional") state tax liability
- Various exceptions and limitations to the above test exist, e.g.,
  - Independent activity limitation
  - Non-commercial government objectives exception
  - Specific and compelling local interest exception

* W. Hellerstein and D. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 Cornell L. Rev. 789 (1996)

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"Coercive Power" Defined

- "Coercive power" is the authors' primary conceptual tool for delineating permissible incentives from impermissible discrimination
  - Not a self-defining phrase, but a term of art
- Premise: dormant CC prohibits state regulation of IC … and state tax laws affecting activities carried on across state lines regulate IC. Impermissible regulation of commerce via a tax incentive occurs if the tax incentive reduces the effective tax rate of an "existing" tax liability
  - "Regulation" does not include every genre of "economic distortion"
  - C.f., Peter Enrich's economic distortion prohibition

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"Coercive Power" Defined (Cont'd)

- The linchpin of when coercive power is implicated by a tax incentive, subject to some venial distinctions, turns on whether it will apply to a taxpayer with "existing" obligations
  - Coercive power is not implicated if a tax incentive relates to a situation where taxpayer's actions will subject it to "additional" obligations, and the tax incentive is not tied (arguably) to any independent activities. For instance,
    - A property tax exemption only tied to the ownership and use of property would not constitute impermissible discrimination
    - However, a property tax exemption tied to any conditions, e.g., in-state jobs or business activities, would be impermissible
    - Authors refer to this as their "independent activities" standard

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"Coercive Power" Defined (Cont'd)

- Exceptions to finding coerciveness include conditions tied to **"aesthetics, the remediation of externalities, or other essentially non-commercial government objectives"**
  - For instance, select noncommercial purposes might include an income tax credit for pollution abatement equipment
- Authors acknowledge difficulty of applying this test when noncommercial purposes might be tied to independent activities
  - For example, a tax incentive that targets reducing unemployment in a depressed area (prohibited) along with visual blight and burgeoning crime (permissible)

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Observations Of HC Approach

- Complex to grasp and administer
- No “coercive/non-coercive” standard found in Court’s decisions
  - Various exceptions and limitations to general approach exist which will require fine judicial distinctions
  - Will find many tax incentives historically relied on by the states to be impermissible
  - Adoption would result in greater disruption to current tax systems than other alternatives causing states and taxpayers to incur high costs simply to change use to other mechanisms (e.g., subsidies, tax incentives aimed at an “additional” tax liability) that result in the same economic consequences

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Observations Of HC Approach (Cont’d)

- HC theory relies on a mixture of “form” and “substance” arguments to reach its desired result leaving unanswered questions as to which focus controls in many given situations
  - Whether a tax incentive is coercive should depend on its ‘practical or economic effect’ and on ‘economic realities’” (*substance*).
    - Coercive principle, however, turns on whether tax incentive aimed at an “existing” or “additional” tax liability (*form*)
  - Coercive principle anticipates some situations where “additional tax” distinction should not control, e.g., the “independent activity” limitation (*substance*)
    - Analysis primarily proceeds as if each state’s taxing statute should generally stand or fall on its own terms (*form*)

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Observations Of HC Approach (Cont'd)

- Approach fails to meaningfully distinguish between opportunities to reduce "existing" taxes on activities already subject to tax and avoiding "additional" taxes on activities not subject to tax
- Analysis fails to observe potential for tax authorities to "camouflage" tax incentives applicable to "additional" taxes within an "existing" liability
  - What should be result if tax incentive can only be applied against "additional" income taxes (e.g., determined via "specific accounting") within an "existing" income tax liability? See, e.g., CA Enterprise Zone Credits.

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Observations Of HC Approach (Cont'd)

- The coercive/non-coercive principle favors relocation and expansion (additional tax), but not retention initiatives (existing tax)
  - Permitting a broad analogy for illustration sake, by permitting tax incentives that generate "additional" taxes, in large part the approach restates accepted understanding that disparate tax treatment that benefits protected ("additional tax") commerce to the detriment of intrastate ("existing tax") commerce is outside the scope of CC protection
    - Stated differently, in large part, the second (coercive powers) principle is a reciprocal of the first principle, i.e., a state may not benefit intrastate ("existing tax") commerce to the detriment of protected ("additional tax") commerce
- Once the above is recognized, it becomes clear that remaining limitations embodied in the coercive power prong are line drawings based on select legal principles, distinctions and arguments

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Observation Of HC Approach (Cont'd)

- For instance, HC advance no compelling justification for applying coercive principle on a tax-by-tax and/or accounting convention basis. Thus, for example,
  - What if state allows a sales tax credit to be applied against taxpayer's income tax liability? Not within state's coercive power?
  - Why shouldn't taxpayer's "existing" tax obligations implicate the state's coercive machinery in other "additional" tax areas, e.g., in-state property purchases otherwise subject to sales tax acquired to further leverage a state's single factor sales apportionment formula?
    - By ignoring this "force of attraction" potential, HC theory may elevate form over substance and implicitly sanction "backdoor" tax regulations of commerce
  - Is the "existing obligations" test fair if taxpayer can create/sever nexus at will, e.g., PL 86-272, Quill, a state's negative nexus rules?
  - Assume a unitary group sets up a new company to take advantage of a tax incentive, should constitutionality of tax incentive turn on whether state requires ("existing" tax), prohibits ("additional" tax), or permits a group return?

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Observation of HC Approach (Cont'd)

- Unclear when coercive powers outside the tax area should be applied to tax incentives
  - If taxpayer has no activities in state, why should "independent activities" standard apply?
  - If taxpayer has existing tax obligations, but not with regard to a sales or other similar transaction tax, why impose an independent activities standard?
    - Independent activities standard a quasi-surrogate for determining coercive power against range of all taxes?
      - Stated differently, does the independent activities standard serve as a limitation of when state's coercive power will be ignored?

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Observations Of HC Approach (Cont'd)

- Because applicability of coercion rule unclear in many respects between operational and transactional based taxes
  - May foster form over substance even with regard to a singular type of tax that can be computed in different ways, e.g., gross receipts taxes vs. income taxes, and credit method vs. additive and subtractive method VATs
  - Appears reasonable to expect that results in this area will vary depending upon lower courts' constructions
    - While awaiting U.S. Supreme Court clarification, differing constructions will spawn numerous sets of non-uniform rules among the states

PHILIP M. TATAROWICZ & REBECCA F. MIMS-VELARDE

"Benefits And Burdens" Theory

The Benefits And Burdens Theory*

- A tax incentive that relies exclusively on in-state activities in determining an effective tax rate does not have a "negative" (but rather has a "neutral") effect on interstate commerce
  - A tax incentive that benefits in-state activities, but is neutral as to out-of-state activities is permissible
- Stated from the negative, a tax statute that "penalizes" (by looking to both in-state and out-of-state) activities is impermissible
  - A tax statute that attempts to "divert" activities (via "penalties") from other states into the state, as opposed to "encouraging" increased level of activities in the state (via "neutral" means) is impermissible

* Philip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879 (1986)

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TMV Observations

- TMV approach recognized that Court's benefit and burden analysis were two sides of same coin
- By proffering an artificial definition of when the other side of a benefit coin should be viewed as "neutral" and not a "burden" TMV approach attempted to distinguish permissible from impermissible disparity right above universally accepted prohibited tariffs
  - TMV did not see the value of line drawing that would disrupt expectations concerning hundreds of tax incentives and cause judicial/legislative chaos when (arguably) other mechanisms, e.g., subsidies, would remain to achieve the same economic result
  - TMV's conceptual model would apply equally to "inbound" and "outbound" activities
- Thus, other side of benefit coin treated as "neutral" where disparity results in an out-of state (State B) opportunity cost from inaction in State B, rather than from an immediate in-state (State A) cost from activities conducted in State B

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HC's Observations of the TMV Approach

- Approach is not as useful as the HC approach because it:
  - Fails to meaningfully distinguish between incentives that penalize vs. reward
  - Court has stated that the Commerce Clause brooks no distinction between laws that benefit in-state activity and those that burden out-of-state activity
  - Approach relies upon only the first of the two core principles advanced in the HC approach

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PE's Observations Of The TMV Approach

- Court's decisions frequently note the improper burdens placed on out-of-state business, products or activities
- Works well with Westinghouse, but not other cases, e.g., a benefit on one side is a burden on the other side. Thus, a tax subsidy for in-state activities is a penalty for out-of-state competitors. Two sides of the same coin.
- Once the differential impact is understood, its unclear what work the distinction is to do.

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Summary (Observations) Of Differing Approaches

- Approaches represent a range from all tax incentives are invalid to … all valid because the dormant CC should not apply to CAT's discrimination prong
- Other than Zelinsky, all approaches assume some "floor" of impermissible incentives
  - Common floor appears to include tariffs and actions that penalize in-state tax burden for out-of-state activities
  - Zelinsky's arrival at this point is purely mechanical due to his call to abandon dormant CC analysis and do not necessarily reflect his views concerning incentives
  - Given Zelinsky belief that the matter of incentives should be reserved to the legislature, he is hereafter excluded from this comparison of judicial based views
- Other than Michael, remaining three approaches assume court never intended a broad application of its statement that a state may not foreclose tax-neutral decision making

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Summary (Observations) of Differing Approaches (Cont'd)

- Other than, perhaps, recognizing a state's power to grant most forms of subsidies, approaches represent a range of views concerning what should be allowed as a permissible tax incentive
  - The narrower the view, the less chance that a permissible incentive might inadvertently permit some unwanted form of impermissible "discrimination"
  - This is not surprising given that the narrower the view of what should constitute a permissible tax incentive reflects a closer alignment to the Court's admonishment not to interfere with tax-neutral decision making and, thus, reduces the opportunities for a state to "camouflage" otherwise discriminatory enactments

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Summary (Observations) of Differing Approaches (Cont'd)

- Virtually all approaches claim certain common aspects of their proposed standards illustrating the collective and different line drawing advanced by each theory. Example:
  - Determinations should turn on practical effects
  - Application requires focus on the nature of the injury alleged
  - Exceptions should not drive the general rule

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APPENDIX B

RECOGNIZING DILEMMA AND NATURE OF PROBLEM CREATED BY PERMISSIBLE TAX INCENTIVES

Permissible Tax Incentives Limit CC Anti-Discrimination Safeguards

Nature of Problem

- Whatever the scope of the area carved out from the dormant Commerce Clause (CC) anti-discrimination prong to define "permissible tax incentives" (tax incentives), the potential for lawmakers to camouflage otherwise impermissible discrimination exists
  - This is not a new problem
  - It is an inherent characteristic of creating an exclusion within an otherwise prohibited area; or, stated differently, another illustration of how once a line is drawn, things may be artificially re-characterized to move from one side of the line to the other
- This problem becomes more acute with the wider the carve out
  - For example, more opportunities to camouflage exist with the greater number of taxes (e.g., income, sales/use, ad valorem) and/or activities (e.g., job training, capital investment) covered by the definition of a tax incentive

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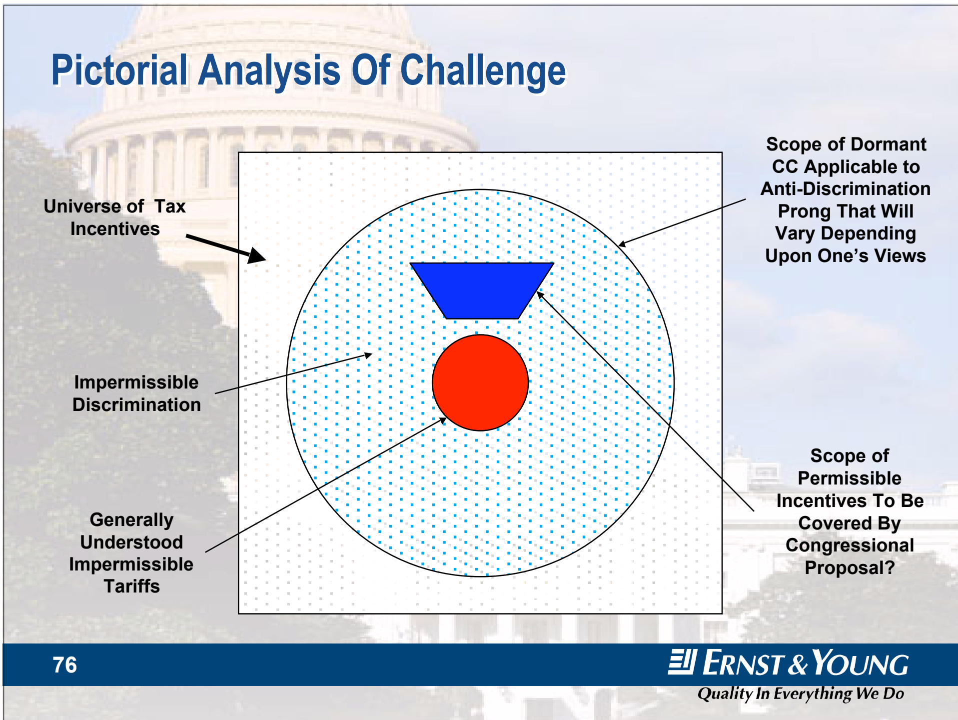

Illustration of Problem

- Example A (Income Based Tax)
  - Situation One. State A allows all corporations a dividends received deduction (DRD), but only to extent paid out of earnings and profits (E&P) previously subject to tax in State A
    - The state's DRD impermissibly discriminates*
  - Situation Two. State A does not allow a DRD, but allows payees a tax incentive and/or subsidy that achieves the same economic consequences formerly realized by the impermissible DRD.
    - No discrimination assuming subsidy is not too closely tied to an otherwise discriminatory tax provision
      - See, e.g., West Lynn Creamery Inc. v. Healy, 512 US 186 (1994)

* C.f., Farmer Bros. Co. v. FTB, 108 Cal. App. 4th 976 (2003), *cert. den'd*, 2004 U.S. LEXIS 1055 (2004) (disallowed DRD for E&P not subject to CA tax) and Hunt-Wesson, Inc. V. FTB, 528 U.S. 458 (Feb. 22, 2000), *rev'g,* No. A079969, Cal. Ct. App., 1st App. Dist., Dec. 11, 1998 (unpublished decision) (disallowed rule that required non-domiciliary to offset their interest expense by nonbusiness dividend income). See, also, Fulton Corporation v. Faulkner, 516 U.S. 325 (1996) (NC intangibles tax on a fraction of the value of corporate stock owned by NC residents inversely proportional to the corporation's exposure to the NC income tax).

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Illustration of Problem (Cont'd)

- Example B (Sales and Use Tax)
  - Situation One. Assume State A imposes a sales/use tax on prefabricated housing at 10% of taxable base. Assume further, that if built in State A, only cost of materials ($200) is subject to State A's sales tax; however, if built in State B, cost of materials ($200) plus labor ($100) is included in base of use tax. Thus, in-state manufacturers would be subject to a tax of $20, but out-of-state manufacturers would be subject to a tax of $30
    - Use tax impermissibly discriminates.*
  - Situation Two. Assume sales and use tax bases are identical at $300 (materials plus labor), but State A offers a tax incentive for in-state labor investments and/or a subsidy equal to $10. Thus, in-state manufacturer pays net $20, but out-of-state manufacturer pays $30
    - No discrimination assuming tax incentive does not negate beneficial impact of the compensatory tax doctrine and subsidy is not too closely tied to an otherwise discriminatory tax provision
      - See, e.g., Maryland v. Louisiana, 451 US 725 (1981) and West Lynn Creamery Inc. v. Healy, 512 US 186 (1994)

* C.f., Halliburton Oil Well Cementing Co. v. Reily, 373 U.S. 64 (1963). Also see, Associated Industries of Mo. v. Lohman, 511 U.S. 641 (1994) (Court struck down a statewide use tax designed to compensate for local sales taxes, because the sales tax rate imposed by various localities was less than the state's use tax rate.)

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Illustration of Problem (Cont'd)

- Example C (Gross Receipts Tax)
  - Situation One. Assume State A imposes a GRT on manufacturers and wholesalers, but provides a multiple activities exemption that exempts either
    - (a) An in-state manufacturer/wholesaler from the wholesaling tax, or
    - (b) An in-state manufacturer/wholesaler from the manufacturing tax
    - The exemptions in both (a) and (b) constitute impermissible discrimination.*

* See, Armco, Inc. v. Hardesty, 467 U.S. 638 (1984) and Tyler Pipe Indus. v. Washington State Dep't of Revenue, 483 U.S. 232 (1987)

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Illustration of Problem (Cont'd)

- Example C (Gross Receipts Tax) (Cont'd)
  - Situation Two. Same as above, but in lieu of the multiple activities exemption, State A provides in (a) and (b) a tax incentive and/or subsidy to manufacturers for in-state activities that roughly approximates the amount of the manufacturing tax otherwise due
    - No discrimination assuming subsidy not too closely tied to an otherwise discriminatory tax provision
      - See, e.g., West Lynn Creamery Inc. v. Healy, 512 US 186 (1994)

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Illustration of Problem (Cont'd)

- Example D (Gross Receipts Tax)
  - Situation One. State A imposes a GRT on providers of health care services, but provides an exemption for sales made to other in-state providers of health care services that are subject to State A's GRT
    - Impermissibly discriminates because exemption allowed only for receipts from in-state health care providers
  - Situation Two. Same as above, but in lieu of exemption, State A provides a tax incentive for in-state jobs and training that roughly approximates economic impact of pyramiding GRT
    - Appropriate? Limit definition of tax incentive not to allow benefits in these types of situations?
  - Situation Three. In lieu of a GRT on providers of health care services, to avoid pyramiding of tax, State A imposes a GRT on the health care provider entity that has the legal right to these receipts, i.e., the one receiving payment for the services from the patient or another third party payer. Thus, if work is subcontracted, ultimate service provider can only deduct gross receipts from buyers of service who paid the GRT to State A
    - Does tax impermissibly discriminate against interstate commerce? No, per Mayo Collaborative Servs. V. Comm'r of Revenue, 2004 Minn. Tax LEXIS 52 (Minn.T.C., 2004)

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Illustration of Problem (Cont'd)

- Example D (Gross Receipts Tax) (Cont'd)
  - Should a state be able to address in-state pyramiding of GRT without running afoul of anti-discrimination prong?
  - Does tax violate the fair apportionment and/or the discrimination prongs of CAT?
  - Note, either apportionment of gross receipts or a credit for GRT paid to other states would avoid anti-discrimination prong issues
  - Should tax survive if State A provides a tax incentive to in-state providers based upon in-state investments, e.g., for capital or job training?

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Illustration of Problem (Cont'd)

- Example E (Net Worth Tax)
  - Situation One. State A imposes a NWT on all corporations doing business in the state. For a company incorporated under the laws of State A, its tax base equals the par value of its stock; for a company not incorporated in State A, the tax base equals its capital employed in the state.
    - Tax impermissibly discriminates*
  - Situation Two. State A imposes a NWT base equally on domestic and foreign corporations; however, State A now grants a tax incentive or subsidy that results in roughly the same economic benefits for those domestic corporations that benefited above
    - No discrimination assuming subsidy not too closely tied to an otherwise discriminatory tax provision
      - See, e.g., West Lynn Creamery Inc. v. Healy, 512 US 186 (1994)
    - As a practical matter, because original discrimination turned on state of incorporation, it may be harder for state to identify a tax incentive whose economic benefits will fall to domestic but not foreign entities, as compared to in-state versus out-of-state activities
    - To preserve this limitation, should definition of tax incentive not allow benefits to turn on whether a corporation is domestic or foreign?

* C.f., South Central Bell Telephone Co. v. Alabama, 526 U.S. 160 (1999).

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Illustration of Problem (Cont'd)

- Example F (Property Tax)
  - Situation One. State A imposes an ad valorem tax on real property and provides an exemption for charitable organizations unless such organizations principally use the property for the benefit of nonresidents
    - Tax exemption impermissibly discriminates*
  - Situation Two. Same as above, but with the conditional exemption removed, and State A enacts a real property tax incentive based on number of State A residents who directly benefit from the eleemosynary activities of a charitable organization
    - Should tax incentive camouflage the otherwise discriminatory tax exemption?

* C.f., Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine, 520 U.S. 564 (1997)

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Observations

- Potentially any element of a tax lends itself to camouflage as a tax incentive and/or subsidy
- The ease in which lawmakers will be able to re-characterize impermissibly discriminatory taxes will depend upon achieving rough approximation of economic benefits within class of desired beneficiaries via the scope of Congressionally approved tax incentives
  - If one attributes income to either capital or labor, tax incentives that would apply to these sources of income would be the vehicles potentially available to camouflage otherwise impermissible discrimination
- Assuming tax incentives are ultimately found permissible by the Court, one could credibly observe that tax provisions found impermissibly discriminatory under the CC are attributable, at least in part, to sloppy legislative drafting
- As illustrated by the next few slides, viewed mathematically, any element of a tax lends itself to camouflage and the potential for abuse

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Pro Forma Income Tax Formula

Type of Credit	Notes/Examples
1. Gross Receipts (Exclusions) Taxable Gross Receipts	1. New Mexico provides an exclusion for Gross Receipts, See Appendix A, page 46.
2. Addition Modifications (Subtraction Modifications) Taxable Income	2. California Enterprise Zone expense deduction, see Appendix A, page 20.
3. (Non-Business Income) Apportionable Income	3. Connecticut Hartford Financial Services Export Zone, see Appendix A, page 22.
4. Apportionment Fraction State Taxable Income	4. Enterprise zone facility and payroll excluded from Ohio numerator, see Appendix A, page 27.
5. (Tax Credits) Tax Payable	5. Approximately 43 states offer similar incentives.
6. (Tax Rebates/Abatements) Tax Paid	6. New York – refundable investment tax credit for "new businesses."

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Pro Forma Sales and Use Tax Formula

Type of Credit	Notes/Examples
1. Gross Sales (Exempt Sales (i.e. EZ Purchases)) Net Sales Subject to S/U Tax S/U Tax Paid	1. States may exclude purchases made in an Enterprise Zone from sales/use tax. See Ark. and Conn. sales/use tax credits, Appendix B, page 2.
2. Refund of sales tax paid for eligible purchases, i.e. qualified equipment in qualified activities	2. See Hawaii refund of capital goods excise tax, Appendix B, page 3.
3. Credit for sales/use tax paid on Corporate Income Tax Return	3. See California Enterprise Zone sales and use tax credit, Appendix B, page 2.
4. Credit for portion of wages paid in Enterprise Zone against sales tax liability	4. See Florida EZ Jobs Credit Against sales tax, Appendix B, page 3.
5. Rebate a percentage of new state revenue from sales/use and payroll taxes.	5. See Utah Aerospace and Aviation Devel. Credit, Appendix B, page 7.
6. Sales/use tax deferral (possibly permanent) for purchases in an "eligible" county.	6. See Washington Sales/Use Tax Deferral/Forgiveness Program, Appendix B, page 7.

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Pro Forma Property Tax Formula

Type of Credit	Notes/Examples
1. Reduced assessment rate on property located in an Enterprise Zone.	1. See Ariz. Property assessment rules for real and personal property in an EZ (rate reduced from 25% to 5%), Appendix C, page 2.
2. Credit on corporate income tax return for property taxes paid on certain equipment.	2. See Connecticut property taxes Paid on electronic data processing equip. credit, Appendix C, page 2.
3. Value of Ppt. subject to assessment (exempt full/partial Ppt. in zone) Net value subject to assessment property tax paid	3. See Connecticut Export Zone and Distressed Municipality Exemptions, Appendix C, page 2.
4. Property tax abatement	4. See New Jersey abatement for property placed in an urban EZ, Appendix C, page 6.

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