
The Legal Front

Litigation and Tax Incentives After the Downfall of Ohio's ITC

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Tax Incentives

State legislatures and policymakers love “economic development tax incentives.” By contrast, taxpayers and opponents of “corporate welfare” love to hate them. For years states have been developing tax schemes to lure businesses inside their borders and encourage businesses already there to increase their local investment. Tax incentives are designed to encourage economic development through increased capital investment and employment, which, in turn, is supposed to generate additional tax revenue. Whether they actually work is a subject that has been widely debated. Nonetheless, tax incentives are a seemingly powerful tool when states attempt to entice big business.

Most, if not all, states have enacted statutes designed to encourage economic development through corporate tax relief.¹ At a basic level, tax incentives are used to make up for a state's inherent deficiencies. For example, some states have a better climate or geography than others, some have a better labor base, and yet others have better business opportunities. As a result, less desirable states have a particular reason to rely on incentives to attract businesses.

Eliminating tax incentives could improve states' tax systems and economic development by freeing up revenue that could be used more productively.

Recently, however, tax incentives have come under fire, and states might soon have to change the way they deal with economic development. *Cuno v. DaimlerChrysler*,² which invalidated Ohio's investment tax credit as unconstitutional discrimination against interstate commerce, combined with pending litigation, may force states to alter the way they attract

¹ Chris Micheli, “A 50-State Comparison of Tax Incentives for Manufacturing Equipment Purchases,” *State Tax Notes*, June 9, 1997, p. 1739, 97 *STT* 111-28, or *Doc* 97-16619.

² 383 F.3d 379, amended by 386 F.3d 738 (6th Cir. 2004). (For the ruling, see *Doc* 2004-1747 or 2004 *STT* 173-28.)

businesses. It's not all bad news for states, though. Tax incentives are not a cost-effective means of stimulating economic growth, investment, or job creation. Eliminating tax incentives could improve states' tax systems and economic development by freeing up revenue that could be used more productively. It could also ease the pressure on states to engage in the so-called race to the bottom, and in the end, *Cuno* and its progeny might “save the states from themselves.”³

The Cuno Effect

On September 2, 2004, the U.S. Circuit Court for the Sixth Circuit issued an opinion in *Cuno*. The facts in *Cuno* are not unique. DaimlerChrysler agreed to invest over \$1 billion and create thousands of jobs in Ohio in exchange for approximately \$280 million in tax incentives. The tax incentives included an ITC, which was a nonrefundable franchise tax credit for purchases of machinery and equipment if the machinery and equipment was installed in Ohio, and a property tax exemption. Charlotte Cuno and other plaintiffs — residents of Ohio and Michigan, and several small businesses — challenged the tax incentives on the grounds that they violated the Commerce Clause of the U.S. Constitution.

The Sixth Circuit struck down Ohio's ITC as unconstitutional discrimination against interstate commerce in violation of the Commerce Clause. Although it invalidated the ITC, the Sixth Circuit upheld Ohio's property tax incentives for businesses that agree “to establish, expand, renovate or occupy a facility and hire new employees, or preserve economic opportunities for existing employees”⁴ in impoverished areas. The Sixth Circuit determined that the property tax incentive did not violate the Commerce Clause because it did “not impose specific monetary requirements, require the creation of new jobs, or encourage a beneficiary to engage in an additional form of commerce independent of the newly acquired property.”⁵

DaimlerChrysler's later motion for a rehearing was denied, although a stay was entered in the case. The stay is in effect until the U.S. Supreme Court disposes of the case, or if a petition for certiorari is not filed, until 90 days after the decision was issued. A petition for certiorari had not been filed at the time of this article's publication. On April 7, however, Justice

³ Peter D. Enrich, “Saving the States From Themselves: Commerce Clause Constraints on State Tax Incentives for Business,” 110 *Harvard Law Review* 377 (1996); Michael Mazerov, “The Ohio Investment Credit Decision: Modest but Helpful ‘Arms Control’ in the ‘Economic War Between the States,’” *State Tax Notes*, Mar. 21, 2005, p. 849, 2005 *STT* 53-1, or *Doc* 2005-4386.

⁴ 383 F.3d 379

⁵ *Id.*

John Paul Stevens granted DaimlerChrysler's application to extend the time to file a petition with the Supreme Court from April 18 to June 17, so it is expected that the case will be submitted to the Supreme Court for review.

Jumping on the *Cuno* Bandwagon

Cuno is not the only case to challenge a tax incentive. Recently, another lawsuit was filed challenging the constitutionality of two state tax incentives on grounds similar to those presented in *Cuno*. The case, *Olson et al. v. Minnesota et al.*,⁶ was filed in Ramsey County District Court in Minnesota and alleges that the Job Opportunity Building Zones (JOBZ) program and the Biotechnology and Health Sciences Industry Zone (biotech zone) program (collectively, the programs) violate both the U.S. and Minnesota constitutions.

In 2003 Minnesota enacted two programs designed to promote economic development through tax incentives. The first, JOBZ, was established by Minnesota Statutes sections 469.310 to 469.320. The JOBZ program authorized the commissioner of employment and economic development (commissioner) to designate 10 areas in the state as job opportunity zones and up to five areas as agricultural processing facility zones. Local governments can receive a zone designation for property in their jurisdiction by filing applications describing the available workforce, demographic characteristics, anticipated activity, and other relevant characteristics of the zone. If an area is designated as a JOBZ zone, businesses operating in the area that meet employment and investment criteria are given substantial tax breaks. The available tax reductions include a partial property tax exemption, a qualified individual tax exemption on investment income, a sales tax exemption on qualified purchases, and an exemption from corporate franchise tax based on the percentage of the corporation operating within the zone. Several credits are also available, including a jobs credit that is based on payroll within the zone and a dependent care credit. Zones are limited by size and can exist for a maximum of 12 years.

The second of the investment programs, the biotech zone program, is similar to the JOBZ program but with some minor differences. First, the biotech zone incentives are available only to those researching, developing, or manufacturing biotechnology products. Second, the commissioner was authorized by statutes, Minn. Statutes sections 469.330 to 469.341, to establish only a single biotech zone, with priority given to areas close to existing educational or research institutions. There are also some slight differences in the kinds of tax incentives that are available to qualified businesses in the biotech zone. Finally, the biotech zone is limited to \$1 million worth of credits and is scheduled to operate only through fiscal 2005. A significant similarity between the programs, however, is the requirement to be a qualified business under the statutes. Both statutes define a qualified business as a business operating within the zone or a business that relocates to the zone if that business increases its employment in the zone by 20 percent in its first year of operation or makes a capital investment of at least 10 percent of the business's gross revenue in the previous year.

In *Olson*, the plaintiffs, Alec G. Olson and Butterworth LP, allege that the programs violate both the state and U.S. con-

⁶ Ramsey County District Court, Second Judicial District, Case No. 62-C8-05-2727.

stitutions. The plaintiffs have outlined six counts in its complaint. Counts one and two deal with Article X, section 1 of the Minnesota Constitution, which states that "the power of taxation shall never be surrendered, suspended or contracted away."⁷ The plaintiffs allege that the programs surrender the power of taxation to employees of the Department of Employment and Economic Development and local economic development officials. The plaintiffs also claim that the programs result in the execution of contracts with businesses in which the state is banned from taxing for up to 12 years.

Count three alleges that the programs violate due process by exempting favored businesses from taxation while leaving other taxpayers "subject to the full coercive force of the government in meeting their tax obligations."⁸ Count four states that the programs violate the proscription against local or special laws exempting property from taxation or granting a special privilege or immunity from taxation. Count five alleges a violation of the Equal Protection Clause of the U.S. Constitution and the Minnesota Constitution, which requires that "taxes shall be uniform on the same class of subjects."⁹ Finally, count six asserts violation of the U.S. Constitution's Commerce Clause.

When Courts Get Their Say

Before courts can authoritatively decide cases like *Olson*, there must be a final disposition in *Cuno*. There are several potential outcomes for *Cuno* depending on whether a petition for certiorari is filed with the U.S. Supreme Court.¹⁰ Assuming it is filed, the question is then whether the High Court will grant or deny certiorari, and ultimately whether the *Cuno* decision will be upheld or struck down. Assuming that the Court grants certiorari, there is no certainty that *Cuno* would be upheld, even if the Court finds that Ohio's ITC is unconstitutional. For example, if the Court holds that the ITC violates the Commerce Clause, the question could then turn to whether the tax credit is nonetheless constitutional because it falls in one of two exceptions.¹¹ The first exception is when a tax incentive violates the Commerce Clause but is necessary to further a legitimate state interest.¹² The Court has recognized in the past that a state's legitimate interest may justify the imposition of regulations that adversely affect interstate commerce. Of course, the effects must only be incidental, and the Court will look to "whether alternative means could promote this local purpose as well without discriminating against interstate commerce."¹³ The second exception is when the state is acting as a market participant, rather than a market regulator.¹⁴ That exception, while very narrow, permits a state to act in the same capacity as a private company without Commerce Clause concerns.

If the Supreme Court denies certiorari, the holding of the Sixth Circuit remains the law of the land — at least in the Sixth

⁷ *Olson* complaint at 2.

⁸ *Id.*

⁹ *Id.*

¹⁰ It is expected that a petition for writ of certiorari will be filed with the U.S. Supreme Court sometime this summer.

¹¹ *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984); see also Barry Pisano, "*Cuno v. DaimlerChrysler*: Opening Pandora's Box," *Business Expansion Journal*, Apr. 1, 2005.

¹² *Hughes v. Oklahoma*, 441 U.S. 322 (1979).

¹³ *Id.* at 336.

¹⁴ *South-Central Timber Dev. Inc. v. Wunnicke*, 467 U.S. 82 (1984).

Circuit states of Kentucky, Ohio, Michigan, and Tennessee. In this situation, there would likely be dozens of suits filed, similar to *Olson*, challenging the validity of tax incentives across the nation. Currently, there is a case pending in Nebraska, *DeCamp v. State of Nebraska*,¹⁵ and there are potential cases in Oklahoma and North Carolina. Other cases would arise, and courts in the various circuits would have to determine the constitutionality of tax incentives on a case-by-case basis. That could lead to inconsistencies among circuits as to what tax incentives are permitted and how they are administered.

If *Cuno* is expanded nationally or its rationale is accepted by a Minnesota court, it is very likely the Minnesota statutes at issue in *Olson* would be struck down, as they are very similar to the Ohio statutes. The most obvious similarity is that both programs provide credits against corporate franchise tax for investments and purchases made within Ohio or within specific designated areas in Minnesota.¹⁶ In both states, the investments must represent increased economic activity. In Minnesota, businesses qualifying for the credits must increase their employment or capital investment by a set percentage. Under the invalidated Ohio statutes, businesses receive credits depending on how much their individual investment compares with overall new investments within a county.

Assuming that the U.S. Supreme Court grants certiorari, there is no certainty that Cuno would be upheld, even if the Court finds that Ohio's investment tax credit is unconstitutional.

In both lawsuits, the requirement to expand investment forms the crux of the plaintiffs' complaints because the requirements, as the *Olson* plaintiffs said, "induce businesses with Minnesota operations to expand into one of the tax favored zones in Minnesota rather than in some other state."¹⁷ Thus, although there are some differences between the two statutory schemes — such as the types of taxes that are at issue, Minnesota's use of specific eligible zones, and Ohio's overall credit limitation — the primary substance of each scheme is the same: Businesses that increase their investments in particular geographic areas receive substantial tax breaks.

One thing is certain: If *Cuno* remains unchanged, states will have to adjust the way they entice businesses to invest. But is *Cuno* really a "loss" for the states? No, not really. States will inevitably adapt to changes in their economic development plans, and with any luck will take that opportunity to "step back and ask some hard questions about the wisdom of their aggressive business subsidy programs."¹⁸

What Could States Do?

An obvious potential outcome of the ongoing litigation is the outlawing of many types of incentives currently in opera-

tion. If that occurs, the states will have to decide what they will do to attract business and industry. There are several routes the states could take. One course of action already underway is lobbying Congress to pass legislation authorizing states to enact *Cuno*-type incentives. Following *Cuno*, members of Congress representing the states in the Sixth Circuit have called on Congress to clarify the situation. In December 2004, U.S. Rep. Ben Chandler, D-Ky., introduced legislation that would have declared the *Cuno* incentives to "not be considered an undue burden in interstate commerce."¹⁹ Three months later, in a conference call with the National Governors Association, U.S. Sen. George V. Voinovich, R-Ohio, said that the decision to offer incentives should be left up to the states and that they were "part of a package" communities should put together to entice businesses.²⁰

It is likely that broader application of Cuno would lead to a broader-based effort to see it overturned.

One of the main concerns driving the legislation is the affected states' fear that they would be at a competitive disadvantage if the ban on tax incentives applies only to states in the Sixth Circuit. If the U.S. Supreme Court grants certiorari in *Cuno* and affirms the appeals court's decision, the law would apply nationwide, thus removing the incentive for members of Congress from the affected states to continue their efforts. A more likely scenario, however, is that broader application of *Cuno* would lead to a broader-based effort to see it overturned. The tax incentives at issue are very popular, and shortsighted politicians are almost certain to heed the call of industries in their home states and districts to allow the incentives to continue.

A second option for states if the incentives struck down in *Cuno* become more widely unavailable is to offer more property tax exemptions like those that were upheld in the Sixth Circuit's decision. Part of the Ohio statutory scheme that was at issue in *Cuno* permitted local governments to offer property tax exemptions for businesses expanding their operations in economically depressed areas. While striking down the ITC statute, the Sixth Circuit upheld the property tax exemption, finding it did not violate the U.S. Constitution's Commerce Clause because "the conditions for obtaining the favorable tax treatment are related to the use or location of the property itself."²¹ Property tax exemptions are less likely to be found constitutionally infirm than other types of incentives because property taxes are inherently more consistent — states have no power to reach beyond their borders as they can with other taxes.²² Their use, although already extensive, is likely to increase if *Cuno*'s impact is expanded.

¹⁹ H.R. 5427, available at <http://thomas.loc.gov/cgi-bin/query/z?c108:H.R.5427.IH>.

²⁰ Emily Dagostino, "U.S. Senator: Congress Should Act to Reverse Ohio Incentives Decision," *State Tax Notes*, Mar. 7, 2005, p. 652, 2005 STT 40-1, or Doc 2005-4105.

²¹ 383 F.3d 379.

²² CCH State Tax Advisory Board Roundtable Discussion 2004, available at: http://www.findarticles.com/p/articles/mi_qa3646/is_200502/ai_n11827251/print.

¹⁵ Case filed in Lancaster County District Court.

¹⁶ Ohio provides additional bonus credits if the investment is within designated economically depressed areas.

¹⁷ *Olson* complaint at 29.

¹⁸ Quote from Prof. Peter Enrich, via e-mail, dated April 15, 2005.

A third option for states wanting to attract business investment is increased use of direct subsidies. States are still free to pay businesses to relocate within their borders by offering many other enticements, such as low-interest financing. Also, promising to improve infrastructure and other municipal services is a means of attracting businesses that would be permitted under *Cuno*.

It would be a mistake to underestimate the ingenuity of state legislators seeking to attract economic investment.

Finally, if the U.S. Supreme Court upholds *Cuno* or the *Cuno* decision's rationale is adopted by other courts around the nation, states and localities might seek tax credit programs that do not violate the U.S. Constitution's Commerce Clause. The legal questions at issue in tax incentive cases are close ones. Although the three cases primarily relied on by the *Cuno* plaintiffs — *Boston Stock Exch. v. State Tax Commission*, *Maryland v. Louisiana*, and *Westinghouse Electric Corp. v. Tully* — establish a strong line of precedent against using tax credits to the advantage of local business, it would be a mistake to underestimate the ingenuity of state legislators seeking to attract economic investment.²³ Of course, with the other tools listed above at their disposal, it is difficult to see why legislatures would try to walk such a fine line.

What Should States Do?

Now that we have discussed what options are available to states if the *Cuno* incentives become unavailable, a discussion of what states ought to do is appropriate. However, adopting the proposals does not depend on the outcome of *Cuno*, *Olson*, and similar litigation. States can always revoke the tax incentives at issue and several commentators have encouraged them to do so in favor of programs that are practical and that more closely comport with sound tax policy.²⁴

First, any enticement program should conform to what is in many ways the mantra of the tax policy world — broad base, low rates. Investment zone credits violate that standard by

removing property and income from taxation, thus increasing the rate at which eligible property must be taxed. Assuming that the tax burden is a factor businesses consider when deciding where to invest, localities should entice businesses by lowering their overall tax rates, not by granting targeted tax breaks and credits. Lowering the tax rate across the board would benefit all businesses in the area as well as their workforce. Increasing sales and use tax exemptions for business components has also been advocated as a means of attracting business that conforms to widely accepted tax policy norms.²⁵

State and local governments should also make their area more desirable for business by investing in education, infrastructure, and other public services. Those improvements go hand in hand with ending incentive programs because incentive programs cost governments valuable revenue that could be used to hire more teachers and police officers.²⁶ Finally, if states decide to continue to use tax incentives and credits and find a way to make them compatible with *Cuno*, they should shun blanket incentives in favor of those that target a specific business and require a return on their investment. The ITC literature is rife with tales of credits that turned out to be very poor investments for local governments once the benefit for businesses was compared with the number of jobs created.²⁷ Making sure that governments receive a reasonable return on their investment is an absolute must for any business enticement program.

Conclusion

For some time, state and local governments have relied on a variety of tax incentives and credits to persuade businesses to locate in their area. Currently, the legal status of those programs is tenuous. Following the lead of the plaintiffs in *Cuno*, legal challenges to tax incentive programs are in the works. Regardless of the eventual outcome of *Cuno* and related litigation, these suits have provided an opportunity for state and local governments to reexamine their incentive programs, which have been widely criticized as ill-conceived and inefficient. We hope states will use the opportunity wisely and create programs that are sounder from a tax policy standpoint and that require a reasonable return on governments' investments. ☆

²³ 429 U.S. 318 (1977); 451 U.S. 725 (1981); 466 U.S. 388 (1984).

²⁴ Mazerov, *supra*; Joel Michael, letter to the editor, "Business Community Needs to Regain Senses," *State Tax Notes*, Jan 3, 2005, p. 923, 2005 STT 1-8, or *Doc 2005-24285*.

²⁵ Mazerov at 854.

²⁶ Zach Schiller, "Ohio's Vanishing Corporate Franchise Tax," *State Tax Notes*, Nov. 25, 2002, p. 537, 2002 STT 227-32, or *Doc 2002-26098* (citing Ohio's Legislative Budget Office and claiming that tax credits cost the Ohio general revenue fund approximately \$774 million between fiscal years 1996 and 2003).

²⁷ Schiller at 545; *see also* Thomas D. Miller, "State Shelves 'Good Faith' Requirement for Job Credits," *State Tax Notes*, Mar. 7, 2005, p. 680, 2005 STT 40-35, or *Doc 2005-4087*.