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Federal Constitutional Restraints on Tax Competition among the American States

Walter Hellerstein
University of Georgia School of Law, wallyh@uga.edu

FEDERAL CONSTITUTIONAL RESTRAINTS ON TAX COMPETITION AMONG THE AMERICAN STATES

BY

WALTER HELLERSTEIN

FRANCIS SHACKELFORD PROFESSOR OF TAXATION,
UNIVERSITY OF GEORGIA SCHOOL OF LAW, ATHENS, GA, USA.

I. – INTRODUCTION

Interstate tax competition in the United States is as American as apple pie. The U.S. states' provision of tax incentives to encourage economic development within their borders has long been a feature of the American legislative landscape. Today every state provides tax incentives as an inducement to local industrial location and expansion. Indeed, scarcely a day goes by without some state offering yet another tax incentive to spur economic development, often in an effort to attract a particular enterprise to the state (1).

While the existence of tax competition among the U.S. states may come as no surprise, what may be somewhat surprising to the foreign observer is the absence of any explicit restraints on such competition in the U.S. Constitution. One might have thought that one of the world's most economically integrated federal systems, whose very existence arose out of a concerted effort to end harmful economic competition among the states, would include a constitutional injunction akin to the European Community's bar against state aid that "distorts or threatens to

(1) For example, after writing this sentence, I accessed "State Tax Today" for October 26, 2005, from my Tax Analysts computer data base and found the following:

Michigan Governor Approves Credits to Keep Auto Supplier in State

Michigan Gov. Jennifer Granholm (D) on October 25 signed SB 798, which authorizes credits against the state's single business tax to a business that meets several criteria; the bill is aimed at an auto supplier in the city of Cadillac that has threatened to move to another state.

Tax Analysts, "State Tax Today, available at http://services.taxanalysts.com/taxbase/tbnews.nsf/Go?OpenAgent&2005+STT+206-17.

distort competition." (2). Moreover, one might have expected to find, at a minimum, a constitutional bar against discriminatory taxation analogous to the European Community's prohibition against discriminatory taxation of the products of other states (3). Yet no such provisions appear in the U.S. Constitution.

Despite the absence of explicit restraints on interstate tax competition, the U.S. Supreme Court has construed the so-called "dormant" Commerce Clause of the U.S. Constitution to prevent unbridled tax competition among the states. Indeed, as this article goes to press, the U.S. Supreme Court is reviewing a federal appellate court's holding that a state investment tax credit to lure new business to the state discriminated against interstate commerce in violation of the dormant Commerce Clause (4). This article examines the judicially developed rules limiting interstate tax competition in the United States and the constitutional framework out of which they arise.

II. – Overview of constitutional restraints on state tax legislation

The U.S. Constitution imposes no explicit limitation on the individual states' power to burden interstate commerce through regulation, taxation, or subsidies. While the Constitution does grant Congress the affirmative power "to regulate Commerce with foreign nations and among the several States, and with the Indian Tribes" (5), it says nothing about what the states may or may not do in the absence of congressional legislation. Moreover, while Congress has legislated broadly to regulate various aspects of interstate commerce, and has thereby preempted state action to the contrary, it has never legislated to limit generally the power of states to tax or subsidize in a manner that "distorts or threatens to distort" competition in interstate com-

(2) Treaty Establishing the European Community art. 87(1).

(3) Treaty Establishing the European Community art. 90.

(4) *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738 (6th Cir. 2004), *petitions for cert. granted sub nom. DaimlerChrysler Corp. v. Cuno* (No. 04-1704) and *Wilkins v. Cuno* (No. 04-1724) (Sept. 27, 2005).

(5) U.S. Const. art. I, §8, cl. 3.

merce (6). Consequently, if the only restraints on state tax competition were those that appear in the letter of the U.S. Constitution, or in the federal laws "made in Pursuance thereof" (7), there would be virtually no limits on such competition other than the rare state tax provision that might offend some other provision of the Constitution (8).

Despite the absence of explicit constitutional or statutory limitations on state tax competition, however, American constitutional jurisprudence has evolved to impose some restraints on state taxation that might be characterized as a prohibited state aid or a discriminatory tax under Articles 87 and 90 of the EC Treaty. Even though the Constitution's Commerce Clause by its terms is no more than an affirmative grant of power to Congress to regulate commerce among the states (9), the first Chief Justice of the United States (John Marshall) elaborated the view that "became central to our whole constitutional scheme : the doctrine that the Commerce Clause, by its own force and without national legislation, puts it into the power of the Court to place limits upon state authority" (10). Under this so-called "negative" or "dormant" Commerce Clause (11), the U.S. Supreme Court (and inferior courts applying its doctrine) have invalidated the application of literally thousands of state laws and regulations that have been found to burden interstate commerce.

For most of America's constitutional history, then, its courts have been the guardians of the "national common market" (12)

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(6) On occasion, Congress has legislated to limit the states' power to impose discriminatory taxes on interstate commerce or on certain industries. See, *e.g.*, 15 *U.S.C.* §391 (2000) (prohibiting states from imposing electrical energy taxes discriminating against out-of-state purchasers); 49 *U.S.C.* §11503 (2000) (prohibiting states from imposing discriminatory taxes on interstate railroads). But these specific prohibitions bear little resemblance to the broad prohibition on state aids in Article 87 of the EC Treaty, or indeed, to the prohibition against discriminatory taxation in Article 90 of the EC Treaty.

(7) The Supremacy Clause of the Constitution, U.S. Const. art. VI, §6, provides :

The Constitution, and the Laws of the United States which shall be made in Pursuance thereof ... shall be the supreme law of the Land ... any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

The Supremacy Clause provides the constitutional basis for federal preemption of state laws.

(8) For example, a subsidy limited to businesses owned by whites (which would violate the Equal Protection Clause of the Fourteenth Amendment, U.S. Const. amend. XIV, §1) or to churches (which would violate the Establishment Clause of the First Amendment, U.S. Const. amend. I).

(9) See *supra* text accompanying note 5.

(10) Felix FRANKFURTER, *The Commerce Clause Under Marshall, Taney and Waite* 18 (1964).

(11) It is "negative" or "dormant" in the sense that it operates to restrain state authority even without Congress's "affirmative" or "active" exercise of its power to regulate interstate commerce.

(12) *Hunt v. Washington State Apple Advertising Commission*, 432 *U.S.* 333, 350 (1977).

under the authority of the dormant Commerce Clause whose "very purpose ... was to create an area of free trade among the several states" (13). Operating under such indeterminate criteria as whether a state law imposed a "direct" or "indirect" burden on interstate commerce, whether the object of the state legislation was "national" or "local" in character, or whether "the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits" (14), American courts have struck down or sustained state laws that affected interstate commerce based on their judgment whether the state action would give rise to "economic Balkanization" (15).

III. – Commerce clause restraints on state taxes

A. – *Impermissible State Tax Discrimination*

The U.S. Supreme Court has rightly characterized its dormant Commerce Clause doctrine as a "quagmire" (16), recognizing that its hundreds of opinions in this domain "have been 'not always clear ... consistent or reconcilable'" (17). Nevertheless, one form of state legislation that the Court has uniformly condemned under the negative Commerce Clause is state taxation that discriminates against interstate commerce.

The rule prohibiting state taxes discriminating against interstate commerce has been a fundamental tenet of the Court's Commerce Clause jurisprudence from the very beginning (18). Although the concept of discrimination is not self-defining and the scope of the doctrine forbidding discriminatory taxes has never been precisely delineated by the Court, the central meaning of discrimination as a criterion for adjudicating the constitutionality of state taxes on

(13) *McLeod v. J.E. Dilworth Co.*, 322 *U.S.* 327, 330 (1944).

(14) *Pike v. Bruce Church, Inc.*, 397 *U.S.* 137, 142 (1977).

(15) *Hughes v. Oklahoma*, 441 *U.S.* 322, 325 (1979).

(16) *Northwestern States Portland Cement Co. v. Minnesota*, 358 *U.S.* 450, 458 (1959).

(17) *Id.* (quoting *Miller Bros Co. v. Maryland*, 347 *U.S.* 340, 344 (1954)).

(18) See *Welton v. Missouri*, 91 *U.S.* (1 Otto) 275 (1876). In *Welton*, the first case in which the U.S. Supreme Court invalidated a discriminatory tax under the Commerce Clause, the Court struck down a peddlers' license tax imposed only upon dealers in out-of-state goods, as applied to an out-of-state merchant, on the grounds that it discriminated against interstate commerce and was contrary to Congress's will "that interstate commerce shall be free and untrammeled." *Id.* at 282.

interstate commerce emerges unmistakably from the Court's numerous decisions addressing the issue : a tax that by its terms or operation imposes greater burdens on out-of-state goods, activities, or enterprises than on competing in-state goods, activities, or enterprises will be struck down as discriminatory under the Commerce Clause.

For example, the Court has been quick to strike down state taxes that favor local over out-of-state products (19), activities (20), or enterprises (21). Moreover, it has invalidated discriminatory levies whether or not the discrimination is intentional (22). Although the Court has occasionally sanctioned different treatment of interstate and local business (23), its decisions strongly adhere to the principle that "[n]o State, consistent with the Commerce Clause, may 'impose a tax which discriminates against interstate commerce ... by providing a direct commercial advantage to local business'" (24).

B. – *State Tax Incentives as State Tax Discrimination : General Principles*

State tax incentives, whether in the form of credits, exemptions, abatements, or other favorable treatment, typically possess two features that render them suspect under the rule barring taxes that discriminate against interstate commerce (25). First, state tax incentives single out for favorable treatment activities, investments, or other actions that occur within the taxing state. Indeed, if state tax incentives were not limited to in-state activities, they would hardly be worthy of the appellation "state" tax incentive.

Second, state tax incentives, as integral components of the state's taxing apparatus, are intimately associated with the coercive machinery of the state. They therefore fall comfortably within the

(19) See, *e.g.*, *Bacchus Imports, Ltd. v. Dias*, 468 *U.S.* 263 (1984) (invalidating excise tax on liquor from which locally-produced beverages were exempt).

(20) See, *e.g.*, *Westinghouse Electric Corp. v. Tully*, 466 *U.S.* 388 (1984) (invalidating income tax credit limited to corporations engaging in export-related activity in the state).

(21) See, *e.g.*, *South Central Bell Telephone Co. v. Alabama*, 526 *U.S.* 160 (1999) (invalidating state franchise tax favoring in-state over out-of-state corporations).

(22) See, *e.g.*, *Halliburton Oil Well Cementing Co. v. Reily*, 373 *U.S.* 64 (1963).

(23) See, *e.g.*, *General Motors Corp. v. Tracy*, 519 *U.S.* 278 (1997) (sustaining use tax exemption applicable only to purchases of natural gas from local distribution companies).

(24) *Boston Stock Exchange v. State Tax Commission*, 429 *U.S.* 318, 329 (1977) (quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 *US* 450, 457-458 (1959)).

(25) The following analysis is based on Walter HELLERSTEIN & Dan T. COENEN, "Commerce Clause Restraints on State Business Development Incentives," 81 *Cornell Law Review* 789 (1996).

universe of state action to which the Commerce Clause is directed, namely, "action of that description in connection with the State's regulation of interstate commerce" (26). The Court has recognized in scores of cases that state tax laws affecting activities carried on across state lines are "plainly connected to the regulation of interstate commerce" (27).

C. – *State Tax Incentives as State Tax Discrimination: Case Law*

The U.S. Supreme Court's treatment of state tax incentives suggests that the constitutional suspicion surrounding such measures is well justified. Over the past three decades, the Court has considered four taxing schemes involving measures explicitly designed to encourage economic activity within the state. In each case the Court invalidated the measure and did so with rhetoric so sweeping as to cast a constitutional cloud over all state tax incentives.

1. *Boston Stock Exchange*

In *Boston Stock Exchange v. State Tax Commission* (28), the U.S. Supreme Court considered the constitutionality of an amendment to a New York stock transfer tax that created an incentive designed to assist New York stock exchanges. The tax applied to all *transfers* of stock regardless of where the *sale* occurred; because the lion's share of stock transfers was effectuated through New York transfer agents, the tax applied to most stock transfers, even when the sale was effectuated through a non-New York exchange. To encourage stock purchasers to use New York exchanges, the statute was amended to provide reduced rates for certain transfers of stock when the *sale* was made within New York, *i.e.*, on a New York exchange. The Court found that this reduction in tax liability, designed to encourage in-state business activity, offended the Commerce Clause's nondiscrimination principle.

Prior to the statute's amendment, the New York transfer tax was "neutral as to in-state and out-of-state sales" (29) because, regard-

(26) *New Energy Co. v. Limbach*, 486 *U.S.* 269, 278 (1988).

(27) *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 *U.S.* 93, 106 n.9 (1994).

(28) 429 *U.S.* 318 (1977).

(29) *Id.* at 330.

less of where the sale occurred, the same tax applied to all securities transferred through a New York transfer agent. The amendment, however, "upset this equilibrium" (30) because a seller's decision as to where to sell would no longer be made "*solely* on the basis of *non-tax* criteria" (31). Instead, a seller would be induced to trade through a New York exchange to reduce his or her transfer tax liability.

By providing a tax incentive for sellers to deal with New York rather than out-of-state exchanges, the state had, in the Court's eyes, "*foreclose[d] tax-neutral decisions*" (32). Moreover, it had done so through the coercive use of its taxing authority. As the Court noted, "the State is using its power to tax an in-state operation as a means of requiring other business operations to be performed in the home State" (33).

Because tax incentives, by their nature, are designed to "foreclose tax-neutral decisions" by bringing "tax criteria" to bear on business decision making, courts could easily read *Boston Stock Exchange* to mean that a constitutional infirmity afflicts every state tax incentive. Perhaps for this reason, the Court felt moved to observe that its "decision. .. does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry" (34). The Court did not explain, however, how states could effectively pursue this objective under the constraints of its reasoning in *Boston Stock Exchange*.

2. *Bacchus*

In *Bacchus Imports, Ltd. v. Dias* (35), the U.S. Supreme Court encountered an exemption from Hawaii's excise tax on wholesale liquor sales for certain locally produced alcoholic beverages. It was "undisputed that the purpose of the exemption was to aid Hawaii industry" (36). This benign purpose, however, could not sanctify a tax incentive that unmistakably defied the prohibition against taxes that favor in-state over out-of-state products. However legit-

(30) *Id.*
(31) *Id.* at 331 (emphasis supplied).
(32) *Id.* at 331 (emphasis supplied).
(33) *Id.* at 336.
(34) *Id.* at 336.
(35) 468 *U.S.* 263 (1984).
(36) *Id.* at 271.

imate the goal of stimulating local economic development, the Court explained, "the Commerce Clause stands as a limitation on the means by which a State can constitutionally seek to achieve that goal" (37). It was "irrelevant to the Commerce Clause inquiry that the motivation of the legislature was the desire to aid the makers of locally produced beverages rather than to harm out-of-state producers" (38).

The Court in *Bacchus* recognized that "a State may enact laws pursuant to its police powers that have the purpose and effect of encouraging domestic industry" (39) and even declared "that competition among the States for a share of interstate commerce is a central element of our free-trade policy" (40). It was also true, however, that "the Commerce Clause limits the manner in which the States may legitimately compete for interstate trade" (41). Beyond reiterating the ban on discriminatory taxation and applying it to strike down the Hawaii tax, however, the Court offered no new counsel on how far the Commerce Clause prohibition extends.

3. *Westinghouse*

Westinghouse Electric Corp. v. Tully (42) arose out of New York's response to Congress's provision of tax incentives for American corporations to increase their exports. In 1971, Congress accorded preferred status to any entity that qualified as a "Domestic International Sales Corporation" or "DISC" (43). Under the federal tax laws, DISCs were not taxable on their income, and their shareholders were taxable on only a portion of such income. If New York had incorporated the federal DISC legislation into its corporate income tax, it would have suffered a substantial loss of revenue (44). On the other hand, if New York had sought to tax DISC income in full, it risked discouraging the manufacture of export goods within the state (45).

(37) *Id.*
(38) *Id.* at 273.
(39) *Id.* at 271.
(40) *Id.* at 272.
(41) *Id.*
(42) 466 *U.S.* 388 (1984).
(43) I.R.C. §§991-97. In 1984, Congress largely repealed the DISC legislation.
(44) *Westinghouse*, 466 *U.S.* at 392.
(45) *Id.* at 392-93.

With these conflicting considerations in mind, New York enacted legislation that did two things: first, it provided that a DISC's income be combined with the income of its parent for state tax purposes; second, in an effort to "'provide a positive incentive for increased business activity in New York State'" (46), it adopted a partial credit for the parent against the tax on the federally exempt DISC income included in the New York tax base (47). The credit was limited, however, by reference to the percent of DISC receipts from export shipments from New York (48). As result, New York taxed the income attributable to export shipments from New York at 30 percent of the rate applicable to income attributable to export shipments from other states.

After examining the operation of New York's DISC credit scheme (49), the U.S. Supreme Court in *Westinghouse* found that New York's effort to encourage export activity in the state suffered from constitutional infirmities similar to those that had disabled New York's earlier effort to encourage stock sales in the state. Like the reduction in tax liability offered to sellers of securities who effectuated their sales in New York, the reduction in tax liability offered to exporters who effectuated their shipments from New York "'creates ... an advantage' for firms operating in New York by placing 'a discriminatory burden on commerce to its sister States'" (50). It was "irrelevant" (51) to the constitutional analysis that the earlier tax incentives the Court had considered "involved transactional taxes rather than taxes on general income" (52), because a state cannot "circumvent the prohibition of the Commerce Clause against placing burdensome taxes on out-of-state

(46) *Id.* at 393 (quoting New York State Division of the Budget, Report on A.12108-A and S. 10544 (May 23, 1972), reprinted in *Bill Jacket of 1972 N.Y. Laws*, ch. 778, p. 18).

(47) During the tax years at issue, a corporation's New York business allocation percentage, which is employed to determine the amount of a multistate taxpayer's income that is fairly attributable to New York, was determined by taking the average of the ratio of the taxpayer's property, payroll, and receipts in New York to its total property, payroll, and receipts wherever located. N.Y. Tax Law §210.3 (McKinney 1986).

(48) *Westinghouse*, 466 U.S. at 394.

(49) The Court explicated the effect of the DISC credit scheme in detail employing, among other things, a series of hypothetical examples demonstrating that similarly situated corporations operating a wholly owned DISC in New York would face different tax assessments in New York depending on the location from which the DISC shipped its exports. *Westinghouse*, 466 *U.S.* at 400-02 n.9.

(50) *Id.* at 406 (quoting *Boston Stock Exchange v. State Tax Commission*, 429 *U.S.* 318, 331 (1977)).

(51) *Id.* at 404.

(52) *Id.*

transactions by burdening those transactions with a tax that is levied in the aggregate rather than on individual transactions" (53). Nor did it matter "[w]hether the discriminatory tax diverts new business into the State or merely prevents current business from being diverted elsewhere" (54); it was "still a discriminatory tax that 'forecloses tax-neutral decisions'" (55).

4. *New Energy*

The U.S. Supreme Court's most recent encounter (56) with a state tax incentive involved an Ohio tax credit designed to encourage the production of ethanol (ethyl alcohol) in the state. Ethanol, which is typically made from corn, can be mixed with gasoline to produce the motor fuel called "gasohol." Ohio provided a credit against the state's motor fuel tax for each gallon of ethanol sold as a component of gasohol, but only if the ethanol was produced in Ohio or in a state that granted similar tax benefits to Ohio-produced ethanol.

In *New Energy Co. v. Limbach* (57), the Court had little difficulty concluding that this tax incentive failed to satisfy the strictures of the Commerce Clause. It observed that the Ohio provision at issue "explicitly deprives certain products of generally available beneficial tax treatment because they are made in certain other States, and thus on its face appears to violate the cardinal requirement of nondiscrimination" (58). As for the claim that Ohio could have achieved the same objective by way of a cash subsidy, the Court responded that the Commerce Clause does not prohibit all state action favoring local over out-of-state interests, but only such action that arises out of the state's regulation of interstate commerce (59). While "direct subsidization of domestic industry does not ordinarily run afoul of that prohibition; discriminatory taxation of out-of-state manufacturers does" (60).

(53) *Id.*
(54) *Id.* at 406.
(55) *Id.* (quoting *Boston Stock Exchange v. State Tax Commission*, 429 *U.S.* 318, 331 (1977)).
(56) At least prior to *Cuno*. See *supra* note 4 and accompanying text and *infra* notes 68-69 and accompanying text.
(57) 486 *U.S.* 269 (1988).
(58) *Id.* at 274.
(59) *New Energy*, 486 *U.S.* at 278.
(60) *Id.*

5. *Cuno*

In late 2004, the U.S. Court of Appeals for the Sixth Circuit in *Cuno v. DaimlerChrysler, Inc.* (61) struck down Ohio's income tax credit for new in-state investment but at the same time sustained the state's personal property tax exemption for new in-state investment. After reviewing the U.S. Supreme Court's decisions discussed above, the court agreed with the plaintiffs' argument that the income tax credit discriminated against interstate economic activity "by coercing businesses already subject to the Ohio franchise tax to expand locally rather than out-of-state" (62). Paraphrasing plaintiffs' argument, the court observed :

> [A]ny corporation currently doing business in Ohio, and therefore paying the state's corporate franchise tax in Ohio, can reduce its existing tax liability by locating significant new machinery and equipment within the state, but it will receive no such reduction in tax liability if it locates a comparable plant and equipment elsewhere. Moreover, as between two businesses, otherwise similarly situated and each subject to Ohio taxation, the business that chooses to expand its local presence will enjoy a reduced tax burden, based directly on its new in-state investment, while a competitor that invests out-of-state will face a comparatively higher tax burden because it will be ineligible for any credit against its Ohio tax (63).

When it came to the personal property tax exemption for property first used in business in the state, the court took a different view of the incentive's constitutionality under the Commerce Clause. The plaintiffs contended that the property tax exemption discriminated against interstate commerce because of the conditions that Ohio placed on eligibility for the exemption – conditions that required beneficiaries of the exemption to agree to maintain a specified level of employment and investment in the state. They argued that these conditions effectively subjected two similarly situated owners of Ohio personal property to differential tax rates : A taxpayer that agrees to focus its employment or investment in Ohio receives preferential treatment in the form of a tax break, while a taxpayer that prefers to preserve the freedom to hire or invest elsewhere does not.

The court, while recognizing that conditions imposed on property tax exemptions may independently violate the Commerce Clause,

(61) 386 F.3d 738 (6th Cir. 2004).
(62) *Id.* at 743.
(63) *Id.* at 746.

declared that "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" (64). In other words, "an exemption may be discriminatory if it requires the beneficiary to engage in another form of business in order to receive the benefit or is limited to businesses with a specified economic presence" (65). However, if the conditions imposed on the exemption do not discriminate based on an independent form of commerce, they pass muster under the Commerce Clause. The court characterized the conditions imposed on the receipt of the Ohio property tax exemption as "minor collateral requirements ... directly linked to the use of the exempted personal property" (66). The statute required only an investment in new or existing property within an enterprise zone and maintenance of employees. 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.

Finally, the court focused on the differences between tax credits and tax exemptions:

> Unlike an investment tax credit that reduces pre-existing income tax liability, the personal property exemption does not reduce any existing property tax liability. The exemption merely allows a taxpayer to avoid tax liability for new personal property put into first use in conjunction with a qualified new investment. Thus, a taxpayer's failure to locate new investments within Ohio simply means that the taxpayer is not subject to the state's property tax at all, and 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 or its failure to reduce current property taxes (67).

As noted above (68), the U.S. Supreme Court has granted certiorari in *Cuno*, although only with respect to the constitutionality of the investment tax credit. The Court is considering the case as this article goes to press, and a decision is expected by June of 2006. It is possible, however, that the Court will not reach the merits of the case, because there is a question whether the plaintiffs, who are state taxpayers, have a sufficiently concrete interest in the outcome of the dispute to give them "standing" to sue in federal court. Fed-

(64) *Id.*
(65) *Id.* at 746.
(66) *Id.* at 747.
(67) *Id.* at 747 (citing HELLERSTEIN & COENEN, *supra* note 25, at 806-09).
(68) See *supra* note 4.

eral jurisdiction is generally limited to "cases or controversies" (69) arising under the Constitution or the laws of the United States. Should the Court dismiss the case for lack of standing, it presumably would be remanded to the state court, where the litigation would proceed.

D. – *Concluding Comments on the State Tax Incentives as State Tax Discrimination*

In light of the storm of controversy that the *Cuno* decision has spawned, it is fair to ask the question whether *Cuno* is a judicial aberration inconsistent with preexisting dormant Commerce Clause doctrine. I believe that the answer is "No." I could hardly say anything different, because the *Cuno* court, in reaching its conclusion, explicitly relied on the analysis that Professor Dan Coenen and I set forth in an article in the *Cornell Law Review* (70). In our article, we attempted to describe the dormant Commerce Clause doctrine governing state business development incentives and suggested a line of analysis, based on our reading of Supreme Court precedents, that the *Cuno* court embraced. Essentially, as noted earlier (71), we suggested that two core principles underlie the U.S. Supreme Court's state tax incentive decisions. First, the provision must favor in-state over out-of-state activities; second, the provision must implicate the coercive power of the state. If, but only if, both of these conditions are met, do tax incentives violate the dormant Commerce Clause.

All four of the Court's tax incentive decisions described above fall comfortably within the suggested analytical framework. First, in each of the four cases, the state favored in-state over out-of-state activities : in-state over out-of-state sales in *Boston Stock Exchange*; in-state over out-of-state production in *Bacchus* and *New Energy*; and in-state over out-of-state exportation in *Westinghouse*. Second, in each of the four cases, the coercive power of the state gave the tax incentive its bite. In *Boston Stock Exchange*, taxpayers would

(69) Article III of the U.S. Constitution limits federal jurisdiction to "cases or controversies" arising under the Constitution or laws of the United States. In *Cuno*, the Court, on its own initiative, specifically asked the parties to brief and argue the following question : "whether respondents have standing to challenge Ohio's investment tax credit." *DaimlerChrylser Corp. v. Cuno*, No. 04-1704 (together with *Wilkins v. Cuno* (No. 04-1724) (Sept. 27, 2005).

(70) See HELLERSTEIN & COENEN, *supra* note 25.

(71) See *supra* note 25 and accompanying text.

pay higher stock transfer taxes unless they engaged in in-state sales. In *Bacchus* and *New Energy*, taxpayers would pay higher liquor wholesaling or motor fuel taxes unless they sold products manufactured in the state. In *Westinghouse*, taxpayers would pay higher income taxes unless their DISCs shipped their exports from within the state.

At least one significant category of tax incentives, however, would escape invalidation : those tax incentives that are framed not as exemptions from or reductions of *existing* state tax liability but rather as exemptions from or reductions of *additional* state tax liability to which the taxpayer would be subjected only if the taxpayer were to engage in the targeted activity in the state. We suggested that such incentives neither favor in-state over out-of-state investment (except in a sense that should be constitutionally irrelevant) nor rely on the coercive power of the state to compel a choice favoring in-state investment.

A real property tax exemption for new construction in a state, for example, favors in-state over out-of-state investment only if one takes account of the taxing regimes of other states and assumes that a tax would be due if the property were constructed in such other state. But the U.S. Supreme Court generally has refused to consider other states' taxing regimes in determining the constitutionality of a state's taxing statutes. As the Court has explained, "[t]he immunities implicit in the Commerce Clause and the potential taxing power of a State can hardly be made to depend, in the world of practical affairs, on the shifting incidence of the varying tax laws of the various States at a particular moment" (72). If a state's taxing statute must stand or fall on its own terms, a real property tax exemption for new construction in a state would pass muster because no *additional* tax liability could be presumed to result from new construction outside the state. By contrast, each of the tax measures at issue in the Court's tax incentive cases resulted in differential tax liability that was created entirely by the state's own taxing regime, depending on whether the taxpayer engaged in in-state or out-of-state activities.

(72) *Freeman v. Hewit*, 329 *U.S.* 249, 256 (1946); see also *Armco, Inc. v. Hardesty*, 467 *U.S.* 638, 644-45 (1984).

Moreover, insofar as the U.S. Supreme Court has looked to other states' taxing regimes to determine their constitutionality under the Commerce Clause, it has done so only to assure that the tax is "internally consistent." Under the Court's internal consistency doctrine, a tax must not impose a greater burden on interstate commerce than on intrastate commerce on the assumption that the levy is imposed by every state (73). As the Court has explained, "[t]his test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with intrastate commerce" (74). A property tax exemption for new construction in a state would pass the internal consistency test, because one would have to assume that every other state offered the same exemption and, under this assumption, intrastate commerce would be treated no better than interstate commerce.

Beyond the lack of a constitutionally significant favoritism for local over interstate commerce, a property tax exemption for new construction does not implicate the coercive power of the state, at least not in a way that can fairly be characterized as "the State's regulation of interstate commerce" (75). By adopting such an exemption, the state is saying, in effect : "Come to our state and we will not saddle you with any additional property tax burdens. Moreover, should you choose not to accept our invitation, nothing will happen to your tax bill – at least nothing that depends on our taxing regime."

The state's posture in such circumstances stands in contrast to its posture in the tax incentive cases the Court has confronted in the past. In each of those cases the state was saying, in effect : "You are already subject to our taxing power because you have engaged in taxable activity in this state. If you would like to reduce those burdens, you may do so by directing additional business activity into this state. Should you decline our invitation, we will continue to exert our taxing power over you as before, and your tax bill might even go up." These two messages are very different. The lat-

(73) See generally Walter HELLERSTEIN, "Is 'Internal Consistency' Foolish : Reflections on an Emerging Commerce Clause Restraint on State Taxation," 87 *Michigan Law Review* 138 (1988).

(74) *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 *U.S.* 175 (1995).

(75) *New Energy Co. v. Limbach*, 486 *U.S.* 269, 278 (1988) (emphasis omitted).

ter, but not the former, reflects a use of the taxing power to coerce in-state business activity.

Having advanced the foregoing analytical framework to determine the constitutionality of state tax incentives under the Court's dormant Commerce Clause doctrine, we would be the first to recognize – and, in fact, our *Cornell Law Review* article explicitly did recognize – that much of the Court's dormant Commerce Clause doctrine is difficult to discern and that ours was not the only reading that could be given to the Court's precedents. Thus, there is a case to be made – and Professor Peter Enrich has already made it – that a much broader universe of state tax incentives than the one we identified as constitutionally suspect is invalid under a proper reading of the Court's precedents (76). Moreover, there is also a case to be made – and Justices Scalia and Thomas, as well as academics like Professor Zelinsky have already made it (77) – for abandoning any judicial inquiry into the validity of state legislation (or, at least allegedly discriminatory state tax legislation) under the Commerce Clause. Indeed, perhaps the one point on which virtually all observers of the Court's negative Commerce Clause doctrine would agree is that the law in this area is indeterminate. Hopefully, we will get some further guidance on this issue from the U.S. Supreme Court in *Cuno* (78), or perhaps from Congress (79).

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(76) Peter D. ENRICH, "Saving the States From Themselves : Commerce Clause Restraints on State Tax Incentives for Business," 110 *Harvard Law Review* 377 (1996).

(77) See, *e.g.*, *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 *U.S.* 175, 200 (1995) (Scalia and Thomas, J., concurring); *Tyler Pipe Industries, Inc. v. Washington State Dep't of Revenue*, 483 *U.S.* 232, 259-65 (1987) (Scalia, J., concurring in part and dissenting in part); Edward A. ZELINSKY, "Restoring Politics to the Dorman Commerce Clause : The Case for Abandoning the Dormant Commerce Clause Prohibition on Discriminatory Taxation," 29 *Ohio Northern Law Review* 29 (2002).

(78) See *supra* note 68-69 and accompanying text. As there noted, it is possible that the Court will not reach the merits of the case.

(79) See Walter Hellerstein, "*Cuno* and Congress : An Analysis of Proposed Federal Legislation Authorizing State Economic Development Incentives," *Georgetown Journal of Law and Public Policy* (forthcoming 2006).

IV. – Commerce Clause Restraints on State Subsidies

A. – *The Constitutionality of State Subsidies*

When it comes to state subsidies as distinguished from state taxes, there is a dramatic difference in the U.S. Supreme Court's approach to economic competition among the states. Just as the Court has consistently held that the Commerce Clause bars state *taxes* favoring in-state over out-of-state interests, so it has endorsed a countervailing principle that the Commerce Clause permits state *spending* favoring in-state over out-of-state interests. "Direct subsidization of domestic industry," a unanimous Court has declared, "does not ordinarily run afoul of [the dormant Commerce Clause] prohibition" (80).

The Court's explanation for this Commerce Clause dichotomy between state taxes favoring local interests and state spending favoring local interests is that "[t]he Commerce Clause does not prohibit all state action designed to give its residents an advantage in the marketplace, but only action of that description *in connection with the State's regulation of interstate commerce*" (81). Whatever difficulties this distinction may engender (82), the Court has drawn an explicit line between the constitutionality of domestic preference legislation, depending on whether the preference takes the form of the exercise of the state's regulatory or taxing power, on the one hand, or its spending power, on the other.

B. – *Nondiscriminatory State Taxes Linked With Discriminatory State Subsidies*

Notwithstanding the general principle that state subsidies favoring local enterprises ordinarily violate no rule of American constitutional or statutory law, there is at least one circumstance in which the American jurisprudence regarding subsidies more closely resembles the EC Treaty ban on state aids in Article 87. In *West*

(80) *New Energy*, 486 *U.S.* at 278.

(81) *Id.* (emphasis in original).

(82) These difficulties have been traced at length elsewhere. See Dan T. Coenen, "Business Subsidies and the Dormant Commerce Clause," 107 *Yale Law Journal* 965 (1998); Hellerstein & Coenen, *supra* note 25.

Lynn Creamery, Inc. v. Healy (83), the U.S. Supreme Court held that Massachusetts could not constitutionally require milk dealers to make a "premium payment" for milk sold in the state when the proceeds from the payments were earmarked for distribution to Massachusetts milk producers. The Court found that Massachusetts' pricing and rebate scheme could not withstand scrutiny under its precedents striking down discriminatory regulations and taxes :

> Under these cases, Massachusetts' pricing order is clearly unconstitutional. Its avowed purpose and its undisputed effect are to enable higher cost Massachusetts dairy farmers to compete with lower cost dairy farmers in other States. The "premium payments" are effectively a tax which makes milk produced out of State more expensive. Although the tax also applies to milk produced in Massachusetts, its effect on Massachusetts is entirely (indeed more than) offset by the subsidy provided exclusively to Massachusetts dairy farmers. Like an ordinary tariff, the tax is thus effectively imposed only on out-of-state products (84).

Massachusetts defended its pricing and rebate program on the ground that, since each component of the program – a nondiscriminatory tax and a local subsidy – was valid, the combination of the two was equally valid. The Court disagreed. While reiterating its view that "[a] pure subsidy funded out of general revenues ordinarily imposes no burden on interstate commerce, but merely assists local businesses" (85), the Court found that the combination of the subsidy and the tax could not pass muster :

> [R]espondent errs in assuming that the constitutionality of the pricing order follows logically from the constitutionality of its component parts. By conjoining a tax and a subsidy, Massachusetts has created a program more dangerous to interstate commerce than either part alone. Nondiscriminatory measures, like the evenhanded tax at issue here, are generally upheld, in spite of any adverse effects on interstate commerce, in part because "[t]he existence of major in-state interests adversely affected ... is a powerful safeguard against their legislative abuse." However, when a nondiscriminatory tax is coupled with a subsidy to one of the groups hurt by the tax, a state's political processes can no longer be relied upon to prevent legislative abuse ...
>
> Respondent's argument would require us to analyze separately two parts of an integrated regulation, but we cannot divorce the premium payments from the use to which the payments are put. It is the entire program – not just the contribu-

(83) 512 *U.S.* 186 (1994).

(84) *Id.* at 194.

(85) *Id.* at 199. The Court also observed :

We have never squarely confronted the constitutionality of subsidies, and we need not do so now. We have, however, noted that "[d]irect subsidization of domestic industry does not ordinarily run afoul" of the negative Commerce Clause.

Id. at 199 n.15.

> tions to the fund or the distributions from that fund – that simultaneously burdens interstate commerce and discriminates in favor of local producers. The choice of constitutional means – nondiscriminatory tax and local subsidy – cannot guarantee the constitutionality of the program as a whole (86).

Whether or not the Court's distinction between taxes and subsidies is legally or economically sound – and there has been considerable amount of scholarly debate over this issue (87) – courts have had to struggle with the question whether a state subsidy is constitutional. In so doing, they have had to balance the general principle that subsidies are constitutional against the rule of *West Lynn Creamery* that subsidies linked with taxes may be suspect (88).

In *Cumberland Farms, Inc. v. Mahany* (89), for example, the court faced a situation virtually identical to that in *West Lynn Creamery*, except for the fact that the subsidies to the in-state dairy farmers were paid out of the general fund. The court found that *West Lynn Creamery* was not on point "since the Supreme Court did not address the constitutionality of a 'non-integrated' statutory scheme" – *i.e.*, one in which the legislature "had intentionally linked together a tax on milk sales and a rebate to dairy farmers" (90). The court therefore sustained the Maine tax and subsidy because

> a direct link between the tax revenue paid by Cumberland Farms and the subsequent appropriations to Maine dairy farmers from the State's General Fund is lacking. Indeed, assuming the tax ... is nondiscriminatory[(91)], Justice Scalia's concurrence in *West Lynn Creamery* contemplates the factual scenario that is before this Court with approval : "I would ... allow a State to subsidize its domestic industry so long as it does so from nondiscriminatory taxes that go into the State's general revenue fund" (92).

The Minnesota Supreme Court likewise sustained a tax-and-subsidy scheme involving nondiscriminatory waste management fees imposed on all solid waste generated within the jurisdiction where a portion of the fees was used to finance the cost of operating local

(86) *Id.* at 200-201 (citations omitted).

(87) See, *e.g.*, Christopher R. DRAHOZAL, "On Tariffs v. Subsidies in Interstate Trade : A Legal and Economic Analysis," 74 *Washington University Law Quarterly* 1127 (1996); Enrich, *supra* note 76.

(88) This issue is explored in considerable detail in Dan T. COENEN & Walter HELLERSTEIN, "Suspect Linkage : The Interplay of State Taxing and Spending Measures in the Application of Constitutional Antidiscrimination Rules," 95 *Michigan Law Review* 2167 (1997).

(89) 943 F. Supp. 83 (D. Me. 1996), *rev'd on other grounds*, 116 F.3d 943 (1st Cir. 1997).

(90) *Id.* at 87.

(91) And the court held that it was.

(92) *Cumberland Farms*, 943 F. Supp. at 88.

waste processing facilities (93). A public waste-processing facility charged high "tipping fees" to cover the cost of running and financing the facility as well as the cost of a variety of waste and recycling programs. When a major hauler of local waste announced plans to discontinue use of the facility and haul materials out of state, the public facility operator : (1) imposed a charge on all waste generated within the waste facility district; (2) directed that a portion of the resulting revenue be used to pay for the operation of the waste facility; and (3) reduced the tipping fees.

The consequence of these actions was that persons who hauled waste out of state continued to pay full tipping fees (to out-of-state facilities) plus the new in-state waste charge, while persons who hauled waste to the local facility paid the new waste charge but also paid lower tipping fees attributable to that charge. The Minnesota Court of Appeals struck down the tax-and-subsidy scheme under the Commerce Clause on the theory that, as in *West Lynn Creamery*, the linking of a nondiscriminatory tax with a subsidy that inured only to the benefit of local facilities and their users discriminated against interstate commerce (94). In effect, the portion of the "nondiscriminatory" in-state waste charge that was used to reduce in-state tipping fees was imposed only on haulers of waste to out-of-state landfills.

The Minnesota Supreme Court disagreed, finding *West Lynn Creamery* "inapposite" :

> It is constitutionally significant that the waste management tax is levied on residents and occupants of the district rather than upon the waste haulers because it demonstrates that the focus, purpose, and reach of the tax is entirely local. Furthermore, while we recognize that discrimination may occur at many different levels of commerce, we do not believe that the tax in this case imposes any differential burden on out-of-state commerce. The use of the waste generation taxes to pay the debt service on a government owned facility, which benefits users of the facility indirectly through lowered tipping fees, is a far cry from the direct cash subsidy found in *West Lynn* ... Like schools and parks, the waste facility is a municipal service that the government has the right to finance through public fees and taxes, irrespective of whether there may be competing, out-of-state providers. Additionally, unlike in *West Lynn*, the waste generators and in-state waste

(93) *Zenith/Kremer Waste Systems, Inc. v. Western Lake Superior Sanitary District*, 572 *N.W.2d* 300 (Minn. 1997), *cert. denied*, 523 *U.S.* 1145 (1998).

(94) *Zenith/Kremer Waste Systems, Inc. v. Western Lake Superior Sanitary District*, 558 *N.W.2d* 288 (Minn. App. 1997).

haulers adversely affected had the opportunity to participate in the political process under which the tax was determined (95).

V. – Conclusion

The U.S. federal constitutional restraints on tax competition among the states are currently the source of intense controversy. The controversy is attributable to a palpable tension in the U.S. Supreme Court's Commerce Clause jurisprudence. On the one hand, the Court has declared that its decisions "do not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry" (96). On the other hand, the Court has disapproved state tax measures designed to achieve that very objective on the ground that they "foreclose[] tax-neutral decisions" (97) and "'provid[e] a direct commercial advantage to local business'" (98). This tension came to a head in the U.S. Sixth Circuit Court of Appeals' in *Cuno*, now pending before the U.S. Supreme Court, which invalidated an Ohio income tax credit for new investment in the state while sustaining a property tax exemption for the same investment. Although this article has attempted to delineate the Commerce Clause doctrine reflected in the *Cuno* decision, in the end only the U.S. Supreme Court or Congress can resolve the difficulties that the Court's indeterminate doctrine has created.

(95) *Zenith/Kremer Waste Systems, Inc. v. Western Lake Superior Sanitary District*, 572 *N.W.2d* 300, 305 (Minn. 1997), *cert. denied*, 523 *U.S.* 1145 (1998).

(96) *Boston Stock Exchange v. State Tax Commission*, 429 *U.S.* 318, 336 (1977).

(97) *Id.* at 331.

(98) *Id.* at 329 (quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 *U.S.* 450, 457 (1959)).