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

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Summary

In 2005, the Sixth Circuit Court of Appeals held in *Cuno v. DaimlerChrsyler* that Ohio's investment tax credit violated the Commerce Clause of the U.S. Constitution. The case received significant attention because most states have similar credits. In 2006, the Supreme Court held that the *Cuno* plaintiffs lacked standing to challenge the credit in federal court. Because the Supreme Court based its decision on the issue of standing, it did not address whether the credit violated the Commerce Clause. Introduced prior to the Supreme Court's decision, the Economic Development Act of 2005 (H.R. 2471 and S. 1066) would authorize states to offer tax incentives similar to Ohio's investment tax credit.

Like most states, Ohio provides various tax incentives to encourage businesses to locate or expand operations in the state. In 1998, DaimlerChrysler agreed to construct a new assembly plant in Ohio in exchange for various benefits, which were valued at $280 million. One benefit the company was qualified to receive because of the plant construction was Ohio's investment tax credit. This credit was a non-refundable credit against the state's corporate franchise tax for taxpayers who purchased new manufacturing machinery and equipment and installed it in the state.[1] Taxpayers from Ohio and Michigan then brought suit against DaimlerChrysler, Ohio, and several other defendants, alleging, among other things, that the investment tax credit violated the Commerce Clause of the U.S. Constitution.[2] As discussed below, the U.S. district court held that the credit was constitutional, whereas the Sixth Circuit Court of Appeals held the opposite. In 2006, the Supreme Court ordered the case be dismissed because the plaintiffs lacked standing to bring suit in federal court.

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[1] Ohio Rev. Code Ann. § 5733.33. In 2005, Ohio significantly reformed its corporate tax system and has eliminated the credit for taxable years ending on or after July 1, 2005.

[2] The plaintiffs' other claims included an allegation that a property tax exemption provided to DaimlerChrysler by an Ohio municipality and authorized under Ohio law violated the Commerce Clause. Both the U.S. district court and Sixth Circuit Court of Appeals held that the property tax exemption did not violate the Commerce Clause, and the issue will not be discussed in this report.

Commerce Clause

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

In the *Cuno* case, the only issue with respect to the Commerce Clause was whether the tax incentive was discriminatory. There is no simple definition of the term "discriminatory." Instead, the Supreme Court has provided general principles, which are then applied to the specific tax at issue. For example, the Court has declared that a "fundamental principle" of the Commerce Clause is that states may not "impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business."[5] Another general rule is that a state may use its tax system to encourage intrastate commerce and may compete with other states for interstate commerce so long as the state does not "discriminatorily tax the products manufactured or the business operations performed in any other [s]tate."[6]

The Supreme Court has not addressed whether an investment tax credit similar to the one at issue in *Cuno* is discriminatory. Thus, the district court and court of appeals were left to look at the general principles found in the Court's decisions and analogize the Ohio credit to the tax credits in the prior cases. As shown by the opposite outcomes of the two lower courts (discussed below), it is possible to come to different conclusions about the meaning of the Supreme Court's prior cases. The decisions by the district court and court of appeals broadly represent two viewpoints of the Court's jurisprudence.[7] The district court's decision represents the idea that the purpose of the Commerce Clause is to prevent economic protectionism by the states (i.e., to prevent states from helping in-state businesses by penalizing out-of-state businesses). The court of appeals' decision represents the view that the Clause's purpose is to encourage free trade by limiting the state's ability to use its taxing power to coerce taxpayers into conducting business in that state. As seen in the two opinions, there is support in the Supreme Court's prior decisions for both interpretations. The Supreme Court, in holding that the plaintiffs lacked standing

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

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

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

[6] *Id*. at 336-37.

[7] *See e.g.,* Peter D. Enrich, *Saving the States From Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377 (1996); Clayton P. Gillette, *Business Incentives, Interstate Competition, and the Commerce Clause*, 82 MINN. L. REV. 447 (1997); testimony from a hearing on the *Cuno* case held by subcommittees of the House Judiciary Committee on May 24, 2005, available at [http://judiciary.house.gov/Oversight.aspx?ID=164].

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to bring suit in federal court, did not address whether the tax credit violated the Commerce Clause.

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District Court. The U.S. district court, in granting the defendants' motion to dismiss the case for failure to state a claim, held that the investment tax credit did not violate the Commerce Clause.[8] The court began by describing what it believed were the two types of state taxation schemes the Supreme Court had found to be discriminatory.[9] The first was that states could not tax goods imported from other states without imposing a tax on in-state goods, and the court found this was not an issue with the Ohio credit. The second was that a state's tax could not be based on the proportion of a business's activities carried on in that state to the amount carried on in other states. The court described the tax scheme in *Westinghouse Electric Co. v. Tully*[10] as the "paradigmatic example" of what was not allowed under this second rule.[11] In *Westinghouse*, the Supreme Court held that a New York corporate tax credit that lowered the effective tax rate on a company's income as its subsidiary's exports from New York increased relative to those from other states was discriminatory. The district court in *Cuno* noted that the New York and Ohio credits were similar in that an increase in New York activity increased the New York credit and an increase in Ohio activity increased the Ohio credit. However, the court distinguished between the two cases: although an increase in activity conducted outside New York decreased the New York credit, an increase in activity conducted outside Ohio did not decrease the Ohio credit. Based on this distinction, the court held the Ohio credit was not discriminatory.[12]

Sixth Circuit Court of Appeals. The plaintiffs appealed the district court's decision. The U.S. Court of Appeals for the Sixth Circuit held that the investment tax credit violated the Commerce Clause and reversed this part of the lower court's decision.[13] The court began by rejecting the defendants' argument, accepted by the district court, that prior Supreme Court opinions had held that only two types of taxes were unacceptable: those that functioned as tariffs and those that determined the taxpayer's effective tax rate using both in-state and out-of-state activities. The court characterized this view as "primarily concerned with preventing economic protectionism," and the court rejected it because it "rests on the distinction between laws that benefit in-state activity and laws that burden out-of-state activity."[14] The court described this distinction as "tenuous" because the Supreme Court had stated that "virtually every discriminatory statute . . . can be

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[8] Cuno v. DaimlerChrysler, 154 F. Supp. 2d 1196 (N.D. Ohio 2001).

[9] *Id.* at 1203.

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

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

[12] *Id.*

[13] Cuno v. DaimlerChrsyler, 386 F.3d 738 (6th Cir. 2004).

[14] *Id.* at 745.

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viewed as conferring a benefit on one party and a detriment on the other, in either an absolute or relative sense."[15]

Instead, the court of appeals compared the Ohio tax incentives with state tax schemes that the Supreme Court had found to be discriminatory because they involved a state using its taxing power to encourage investment in the state at the expense of investment in other states. The court looked at three cases:

- *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318 (1977), where the Court invalidated part of a New York securities transfer tax. New York imposed a tax on a transfer of securities if a taxable event occurred in the state. Since New York was the only state that taxed securities transfers, the tax placed New York brokers at a disadvantage. The state created incentives to encourage New York sales: if a sale occurred in New York, then nonresidents were taxed at a lower rate and both residents and nonresidents could not be taxed above a certain amount. The court of appeals quoted the Supreme Court as finding that the incentives "foreclosed tax-neutral decisions" and that New York was improperly using "its power to tax an in-state operation as a means of requiring [other] business operations to be performed in the home state," which was "wholly inconsistent with the free trade purpose of the Commerce Clause."[16]

- *Maryland v. Louisiana*, 451 U.S. 725 (1981), where the Supreme Court invalidated a Louisiana severance tax credit that favored in-state natural gas producers. The appeals court quoted the Supreme Court as finding that since the credit "favored those who both own [offshore] gas and engage in Louisiana production" and that the "obvious economic effect of this Severance Tax Credit [was] to encourage natural gas owners involved in the production of [offshore] gas to invest in mineral exploration and development within Louisiana rather than to invest in further [offshore] development or in production in other States," the credit "unquestionably discriminated against interstate commerce in favor of local interests."[17]

- *Westinghouse Electric Corp. v. Tully*, which was discussed above in the section on the district court's opinion and was distinguished by that court. The court of appeals quoted the Supreme Court as stating that the tax scheme "penalized increases in the [export] shipping activities in other states," which meant it placed "a discriminatory burden on commerce to its sister States."[18]

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[15] *Id.*

[16] *Id.* at 744.

[17] *Id.*

[18] *Id.* at 744-45.

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The court of appeals found the Ohio credit to be analogous to these other tax incentives in that the credit, by reducing a business's pre-existing franchise tax liability, coerced businesses into making in-state investments.[19] A business with activities in Ohio would be subject to the state's franchise tax regardless of whether the business made an investment in new property eligible for the tax credit. The business could, however, reduce its existing franchise tax liability by making new investments that would qualify for the tax credit. On the other hand, if the business chose to make the new investments outside of Ohio, it could not reduce its Ohio franchise tax liability. This meant, in the court's view, that Ohio was using its power to tax to coerce businesses subject to the Ohio franchise tax to expand in Ohio rather than in another state.[20] As a result, it held the credit was discriminatory.

Supreme Court. Ohio and the other defendants appealed the decision as it related to the investment tax credit to the U.S. Supreme Court. In 2006, the Court held that the plaintiffs did not have standing to bring the case in federal court and vacated and remanded that part of the court of appeals' opinion for dismissal.[21] The issue of standing had not been addressed by the court of appeals.[22] It was briefly an issue before the district court after the defendants asked for the case, which the plaintiffs had initially brought in state court, to be removed to federal court. The plaintiffs used their potential lack of standing as one reason why the suit should not be removed, but the district court, in approving the removal, stated that the plaintiffs had standing to challenge the tax credit under the "municipal taxpayer standing" rule. That rule derives from a Supreme Court case, *Massachusetts v. Mellon*,[23] in which the Court indicated that a municipal resident could have standing to challenge the illegal spending of money by a municipality because of the special relationship that arose between the resident and municipality due to the later's corporate status. The district court apparently felt that the *Cuno* plaintiffs had standing to challenge the state investment tax credit because they had standing to challenge the other benefits provided to DaimlerChrysler, specifically a property tax exemption provided by an Ohio municipality as authorized under Ohio law.

Before the Supreme Court, the *Cuno* plaintiffs claimed they had standing due to their status as Ohio taxpayers who were injured because the credit reduced the funds available in the Ohio fisc to be used for lawful purposes and therefore imposed a disproportionate burden on them. The Supreme Court, in rejecting their claim, began by noting that standing is an integral part of the "case or controversy" requirement in Article III of the U.S. Constitution and requires plaintiffs show a "personal injury fairly traceable to the defendant's allegedly unlawful conduct and likely to be redressed by the requested

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[19] *Id*. at 743-45.

[20] *Id*. at 743.

[21] DaimlerChrysler v. Cuno, No. 04-1704 and 04-1724, 2006 U.S. Lexis 3956 (2006).

[22] The issue of standing was brought up by the State of Ohio when it asked for en banc review of the panel's decision. *See* The State of Ohio's Petition for Rehearing, at 9-10, Cuno, 386 F.3d 738. The court denied the motion to review the case en banc. Cuno, 2005 U.S. App. LEXIS 1750 (6th Cir. 2005).

[23] 262 U.S. 447, 486-87 (1923).

relief."[24] The Court noted that federal taxpayers generally do not have standing solely because of their taxpayer status to challenge an expenditure of federal funds.[25] This is because such taxpayers' injuries are (1) not particularized to those plaintiffs, but rather common to the general taxpaying public, and (2) hypothetical because whether they will occur or be redressed depends on future actions by a legislative body. The Court concluded that the same reasons for denying standing to federal taxpayers applied to deny standing to state taxpayers, including the plaintiffs in *Cuno*.[26]

The Court also rejected the plaintiffs' contention that there should be an exception to the general rule disallowing taxpayer standing for Commerce Clause challenges, similar to the exception that exists for Establishment Clause challenges.[27] The Court distinguished between the two situations, noting that the injury in taxpayer suits alleging violation of the Establishment Clause was the taxing and spending itself and that the injury could be redressed by enjoining the taxing and spending activity without requiring further legislative action.[28] The Court also reasoned that allowing an exception for Commerce Clause suits would lead to the creation of exceptions for any constitutional provision that implicates a government's taxing and spending powers, and thus be inconsistent with the general rule that disallows taxpayer standing. Finally, the Court rejected the argument that the plaintiffs had standing to challenge the investment tax credit under the theory of supplemental jurisdiction (which would have allowed them to challenge the investment tax credit because they had standing as municipal taxpayers to challenge the property tax exemption provided to DaimlerChrysler by an Ohio municipality), stating that the plaintiffs must have standing for each claim presented.[29]

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Legislation introduced in the 109th Congress

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

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[24] Cuno, 2006 U.S. Lexis 3956 at 18, *quoting* Allen v. Wright, 468 U.S. 737, 751 (1984).

[25] *Id*. at 21-23.

[26] *Id*. at 24-26.

[27] Flast v. Cohen, 392 U.S. 83 (1968).

[28] Cuno, 2006 U.S. Lexis 3956 at 27-30.

[29] *Id.* at 35-38.