1997

Commerce Clause Restraints on State Tax Incentives

Walter Hellerstein

Commerce Clause Restraints on State Tax Incentives

Walter Hellerstein*

INTRODUCTION

The states' provision of tax incentives designed 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.[1] Indeed, scarcely a day goes by without some state offering yet another tax incentive to spur economic development,[2] often in an effort to attract a particular enterprise to the state.[3]

The debate over the efficacy and wisdom of state tax and other business incentives is intense and important,[4] as other

---

* Professor, University of Georgia School of Law. A.B. 1967, Harvard; J.D. 1970, University of Chicago. This Article draws freely from Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 CORNELL L. REV. 789 (1996).

1. *See* Chris Micheli, *A 50-State Comparison of Tax Incentives for Manufacturing Equipment Purchases*, 12 STATE TAX NOTES 1739, 1739 (1997); Mark L. Nachbar et al., *Income Taxes: State Tax Credits and Incentives*, 1180 Tax Mgmt. (BNA) (1994).

2. *See, e.g.*, Russell Garland, *State Extends New Tax Break to Investment Firms*, 13 STATE TAX NOTES 226, 226-27 (1997) (describing tax incentives designed "to lure large investment companies" to Rhode Island); *Is Bay State's Harbor Tax Credit 'In for Rough Sledding'?* 12 STATE TAX NOTES 947, 947 (1997) (relaying letters to the editor that discuss Massachusetts' corporate excise tax credit for the federal harbor maintenance tax paid when shipping into or out of Massachusetts ports).

3. *See, e.g.*, Harriet Hanlon, *Steel or Steal? Gulf States Challenges Alabama's Tax Incentives*, 9 STATE TAX NOTES 923, 923 (1995) (discussing the "Mercedes-Benz legislation" that was enacted "to encourage the location of industrial research facilities in Alabama").

4. *Compare, e.g.*, Richard D. Pomp, *The Role of State Tax Incentives in Attracting and Retaining Business: A View from New York*, 29 TAX NOTES 521 (1985) (concluding, after extensive review, that business tax incentives play only an insignificant role in attracting or maintaining in-state firms and probably result in a needless loss of state revenue) *with* Note, *Problems with*

articles in this Symposium plainly reveal. My purpose here, however, is not to enter this fray. Instead, it is to consider the central legal question that state tax incentives raise under the dormant Commerce Clause of the Federal Constitution: How is a constitutionally benign tax incentive designed to attract industry to a state to be distinguished from an unconstitutionally discriminatory tax incentive designed to do the same thing?

This question reflects a palpable tension in the Supreme Court's Commerce Clause opinions. 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."[5] The Court, however, has disapproved state tax measures designed to achieve that very objective on the ground that they "foreclose[] tax-neutral decisions"[6] and " 'provid[e] a direct commercial advantage to local business.' "[7]

This Article explores the ill-defined distinction between the constitutional carrot and the unconstitutional stick in state tax cases. In examining the restraints that the Commerce Clause imposes on state tax incentives, the Article canvasses the general principles limiting discriminatory state taxation, explores the Court's decisions addressing state tax incentives, and proposes a framework of analysis for adjudicating the validity of such incentives. The Article considers the constitutionality of a variety of state tax incentives within the suggested framework. It concludes that many state tax incentives commonly employed by the states cannot survive Commerce Clause scrutiny while identifying several categories of state tax incentives that should pass constitutional muster.

State Aid to New or Expanding Businesses, 58 S. CAL. L. REV. 1019, 1024-25 (1985) (citing a *Fortune* study showing the practical importance of business incentives). *See also* WILLIAM SCHWEKE ET AL., BIDDING FOR BUSINESS 35 (1994) (noting the weight of scholarly opinion against using development incentives to attract new industry); William J. Barrett VII, Note, *A Proposal to Prohibit Industrial Relocation Subsidies*, 72 TEX. L. REV. 669, 712-13 (1994) (concluding that industrial relocation subsidies are undesirable from an economic and political standpoint). *See generally* Symposium: *The Effects of State and Local Public Policies on Economic Development*, NEW ENGLAND ECON. REV., Mar./Apr. 1997, at 1, 1-147.

5. Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 336 (1977).

6. *Id.* at 331.

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

I. STATE TAX INCENTIVES AS STATE TAX DISCRIMINATION: GENERAL PRINCIPLES

The prohibition against state taxes that discriminate against interstate commerce has been a fundamental tenet of the Court's Commerce Clause jurisprudence from the very beginning.[8] The concept of discrimination, however, is not self-defining, and the Court has never precisely delineated the scope of the doctrine that bars discriminatory taxes. Nonetheless, the central meaning of discrimination as a criterion for adjudicating the constitutionality of state taxes on interstate business emerges unmistakably from the Court's decisions: A tax which 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.[9]

State tax incentives, whether in the form of credits, exemptions, abatements, or other favorable treatment typically share two features that render them suspect under the rule barring taxes that discriminate against interstate commerce. First, state tax incentives single out activities, investments, or other actions that occur within the taxing state for favorable treatment. 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 universe of state action to which the Commerce Clause is directed. While "[t]he Commerce Clause does not prohibit all state action designed to give its residents an advantage in the marketplace,"[10] it plainly applies to "action of

8. *See* Welton v. Missouri, 91 U.S. 275, 282 (1875) (holding unconstitutional a Missouri statute which required the payment of a license tax from persons who sold goods not manufactured in Missouri).

9. *See, e.g.*, Camps Newfound/Owatonna, Inc. v. Town of Harrison, 117 S. Ct. 1590, 1596 (1997) (invalidating exemption for property owned by charitable organizations because exemption excluded organizations operated principally for the benefit of nonresidents); Fulton Corp. v. Faulkner, 116 S. Ct. 848, 861 (1996) (invalidating intangible property tax on corporate stock that applied only to the extent that the corporation did business in other states); Associated Indus. v. Lohman, 511 U.S. 641, 654-56 (1994) (invalidating a statewide use tax on products purchased outside the state insofar as it exceeded equivalent sales tax on products purchased within the state).

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

that description *in connection with the State's regulation of interstate commerce*."[11] And 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."[12]

II. STATE TAX INCENTIVES AS STATE TAX DISCRIMINATION: CASE LAW

The Court's treatment of state tax incentives suggests that the constitutional suspicion surrounding such measures is well justified. Over the past two decades, the Court has considered four taxing schemes involving measures explicitly designed to encourage economic activity within the state.[13] 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.

A. *BOSTON STOCK EXCHANGE*

In *Boston Stock Exchange v. State Tax Commission*,[14] the Court considered the constitutionality of an amendment to a New York stock-transfer tax that created an incentive designed to assist the New York brokerage industry. 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 broker. To encourage stock purchasers to use New York brokers, the statute was amended to provide reduced rates for certain transfers of stock when the *sale* was effected through New York brokers. The Court found that this reduction in tax liability, designed to encourage in-state business activity, offended the Commerce Clause's nondiscrimination principle.

11. *Id.*

12. Oregon Waste Systems, Inc. v. Department of Envt'l Quality, 511 U.S. 93, 107 n.9 (1994); *see also* Walling v. Michigan, 116 U.S. 446, 455 (1886) ("A discriminatory tax . . . is, in effect, a regulation in restraint of commerce among the States.").

13. *See New Energy Co.* 486 U.S. at 271-73; Bacchus Imports, Ltd. v. Dias, 468 U.S. 263, 265 (1984); Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 390 (1984); Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 323-24 (1977).

14. 429 U.S. 318 (1977).

Prior to the statute's amendment, the New York transfer tax was "neutral as to in-state and out-of-state sales"[15] because, regardless 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"[16] because a seller's decision as to where to sell would no longer be made "*solely* on the basis of *nontax* criteria."[17] Instead, a seller would be induced to trade through a New York broker 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 brokers, the state had, in the Court's eyes, "*foreclose[d] tax-neutral decisions*."[18] Moreover, it had done so through the coercive use of its taxing authority. As the Court noted, "the State us[ed] its power to tax an in-state operation as a means of requiring other business operations to be performed in the home State."[19]

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."[20] The Court did not explain, however, how states could effectively pursue this objective under the constraints of its reasoning in *Boston Stock Exchange*.

B. *BACCHUS*

In *Bacchus Imports, Ltd. v. Dias*,[21] the 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."[22] This benign purpose, however, could not sanctify a tax incentive that unmistakably defied the prohibition against

15. *Id.* at 330.
16. *Id.*
17. *Id.* at 331 (emphasis added).
18. *Id.* (emphasis added).
19. *Id.* at 336.
20. *Id.*
21. 468 U.S. 263 (1984).
22. *Id.* at 271.

taxes that favor in-state over out-of-state products. However legitimate 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."[23] 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."[24]

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"[25] and even declared "that competition among the States for a share of interstate commerce is a central element of our free-trade policy."[26] It was also true, however, that "the Commerce Clause limits the manner in which the States may legitimately compete for interstate trade."[27] 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.

C. *WESTINGHOUSE*

Westinghouse Electric Corp. v. Tully[28] 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" (DISC).[29] 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.[30] On the other hand, if New York

23. *Id.*

24. *Id.* at 273.

25. *Id.* at 271.

26. *Id.* at 272.

27. *Id.*

28. 466 U.S. 388 (1984).

29. *See* I.R.C. §§ 991-97 (1988). In 1984, Congress largely repealed the DISC legislation and replaced it with special provisions governing new entities it described as foreign sales corporations (FSCs). *See* I.R.C. §§ 921-27 (1996).

30. *See Westinghouse*, 466 U.S. at 392 (explaining that a budget analyst reported to the legislature that a loss of revenue could amount to 20 to 30 million dollars each year).

had sought to tax DISC income in full, it risked discouraging the manufacture of export goods within the state.[31]

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,' "[32] it adopted a partial credit for the parent against the tax on the federally exempt DISC income included in the New York tax base.[33] The credit was limited, however, by reference to the percent of DISC receipts from export shipments from New York.[34] As a result, New York taxed the income attributable to export shipments from New York at thirty 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,[35] the 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 brokerage activity 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.' "[36] It was "irrelevant"[37] to the

---

31. *See id.* at 392-93.

32. *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).

33. *See id.* 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, is 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 & Supp. 1995).

34. *See Westinghouse*, 466 U.S. at 393-94 (explaining the method of computing DISC credit).

35. The Court explained 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 n.9.

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

constitutional analysis that the earlier tax incentives the Court had considered "involved transactional taxes rather than taxes on general income"[38] because a State cannot "circumvent the prohibition of the Commerce Clause against placing burdensome taxes on out-of-state transactions by burdening those transactions with a tax that is levied in the aggregate . . . rather than on individual transactions."[39] Nor did it matter "[w]hether the discriminatory tax diverts new business into the State or merely prevents current business from being diverted elsewhere";[40] it is "still a discriminatory tax that 'forecloses tax-neutral decisions.' "[41]

D. *NEW ENERGY*

The Court's most recent encounter 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*,[42] 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."[43] 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.[44] While "[d]irect

---

37. *Id.* at 404.
38. *Id.*
39. *Id.*
40. *Id.* at 406.
41. *Id.* (quoting Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 331 (1977)).
42. 486 U.S. 269 (1988).
43. *Id.* at 274.
44. *See id.* at 278.

subsidization of domestic industry does not ordinarily run afoul of that prohibition; discriminatory taxation of out-of-state manufacturer does."[45]

III. STATE TAX INCENTIVES AS STATE TAX DISCRIMINATION: ANALYSIS

A. GIVING THE COURT'S LANGUAGE FULL SWAY

What, then, does the case law teach us about the constitutionality of state tax incentives under the Commerce Clause? A literal focus on key passages in the Court's opinions might well suggest that "all state inducement programs are likely to be unconstitutional."[46] After all, it is the rare state tax incentive that results in "tax-neutral decisions"[47] made "solely on the basis of nontax criteria."[48]

Consider state income taxes. Almost no state income tax incentive—and there are hundreds of them across the country—meets the Court's ostensible requirement of strict geographic neutrality. Alabama, for example, provides an income tax credit for new investment, but only if it occurs in Alabama;[49] Alaska provides an income tax credit for investment in gas processing and mineral development facilities, but only if they are built in Alaska;[50] Arizona provides an income tax credit for taxpayers that increase research activities in Arizona;[51] Arkansas provides an income tax credit for any motion picture production company that spends more than a specified amount producing films in Arkansas;[52] California provides an income tax credit for qualified property placed in service in California;[53] Colorado provides an income tax credit for investment in qualifying Colorado property;[54] Connecticut provides an income tax credit for investing in certain new manufacturing facilities in Connecticut;[55] Delaware provides an income tax credit for in-

45. *Id.*
46. Note, *supra* note 4, at 1049.
47. Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 331 (1977).
48. *Id.*
49. *See* ALA. CODE § 41-23-24(a) (1991).
50. *See* ALASKA STAT. § 43.20.042 (Michie 1996).
51. *See* ARIZ. REV. STAT. ANN. § 43-1168 (West Supp. 1996).
52. *See* ARK. CODE ANN. § 26-4-206 (Michie 1992).
53. *See* CAL. REV. & TAX. CODE § 23649 (West Supp. 1997).
54. *See* COLO. REV. STAT. § 39-22-507.6 (1994).
55. *See* CONN. GEN. STAT. ANN. § 12-217e (West Supp. 1997).

vesting in qualified new business facilities in Delaware;[56] Florida provides an income tax credit for investments in Florida export finance corporations;[57] Georgia provides an income tax credit for taxpayers that increase employment by five or more in designated counties in Georgia.[58] The list goes on and on.[59]

By providing a tax benefit for in-state investment that is not available for identical out-of-state investment, these incentives skew a taxpayer's decision in favor of the former. Each such incentive—in purpose and effect—"diverts new business into the State."[60] Put another way, these incentives deprive out-of-state investments "of generally available beneficial tax treatment because they are made in . . . other States, and thus on [their] . . . face appear[] to violate the cardinal requirement of nondiscrimination."[61]

A similar analysis jeopardizes almost every sales and property tax incentive designed to encourage economic development in the taxing state. Yet most states offer just such incentives. Some states provide sales and use tax exemptions (or credits or refunds) for sales of property purchased for construction of new or improved facilities within the state; others give favorable sales or use tax treatment to property purchased in connection with the relocation or expansion of a business in the state; still others provide sales and use tax exemptions for property used in an enterprise zone within the state.[62] Similarly, a number of states provide property tax incentives for new or expanded facilities in the state.[63] Given the near universality of state sales taxation in this country,[64] and the true universality of local property taxation, sales or property tax

56. *See* DEL. CODE ANN. tit. 30, § 2011(a) (1985).

57. *See* FLA. STAT. ANN. § 220.188 (West 1989).

58. *See* GA. CODE ANN. § 48-7-40(e) (Supp. 1997).

59. One could continue to proceed alphabetically through the states with similar examples. *See* 1 Multistate Corp. Income Tax Guide (CCH) ¶ 180 (1997) (listing current tax credits allowed by each state); Nachbar et al., *supra* note 1 (discussing income tax credits available to businesses in each state).

60. Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 406 (1984).

61. New Energy Co. v. Limbach, 486 U.S. 269, 274 (1988).

62. *See generally* 1 Multistate Sales Tax Guide (CCH) ¶ 975 (1997) (listing state tax incentives for investment in industry).

63. *See* [2 All States] State Tax Guide (CCH) ¶ 20-200 to 20-964 (1997) (listing all property taxes and tax exemptions by state).

64. Forty-five states and the District of Columbia impose a retail sales tax. *See id.* ¶ 60-100 (tabulating state tax rates for retail sale of tangible personal property).

breaks for investment within the state or locality affect many taxpayers' business location decisions. All other things being equal, a rational taxpayer will allocate its resources in a manner that maximizes its after-tax profits; hence it will steer its investments toward the states which offer such tax benefits. Sales and property tax incentives, like income tax incentives, are therefore subject to attack on the ground that they offend the "free trade" purposes of the Commerce Clause[65] by inducing resources to be allocated among the states on the basis of tax rather than nontax criteria.

B. AN ALTERNATIVE READING OF THE COURT'S OPINIONS

1. The Justification for a More Restrained Approach

The astonishing implications of a literal reading of the Court's pronouncements should give us pause. Nonetheless, the four cases in which the Court has considered and struck down state tax incentives make it clear that the Court's rhetoric cannot be dismissed as empty. In its decisions, the Court revealed a willingness to subject a wide array of fiscal measures to exacting scrutiny, striking down sales, income, and transaction taxes. The Court likewise showed no mercy to any form of tax break, invalidating rate reductions,[66] exemptions,[67] and credits.[68] Moreover, the four opinions were written by Justices whose attitudes toward the dormant Commerce Clause span the spectrum from the highly protective "free trade" views of Justice White (*Boston Stock Exchange* and *Bacchus*) to the more moderate views of Justice Blackmun (*Westinghouse*) to the unabashed hostility of Justice Scalia (*New Energy*).[69] Even more significantly, the Justices acted in these cases with an extraordinary degree of consensus. There was not a single dissent on the merits of the Commerce Clause

65. Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 403 (1984) (quoting Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 328 (1977)).

66. *See Boston Stock Exchange*, 429 U.S. 318, 328 (1997). For a discussion of *Boston Stock* Exchange see *supra* Part II.A.

67. *See* Bacchus Imports, Ltd. v. Dias, 468 U.S. 263, 273 (1984). For a discussion of *Bacchus*, see *supra* Part II.B.

68. *See Westinghouse*, 466 U.S. at 407. For a discussion of *Westinghouse* see *supra* Part II.C. *See also* New Energy Co. v. Limbach, 486 U.S. 269, 279-80 (1988). For a discussion of *New Energy* see *supra* Part II.D.

69. *See* Walter Hellerstein, *Justice Scalia and the Commerce Clause: Reflections of a State Tax Lawyer*, 12 CARDOZO L. REV. 1763 (1991) (reviewing Justice Scalia's Commerce Clause jurisprudence).

issue in any one of the Court's four state tax incentive decisions.[70] In short, these cases and the doctrine they espouse must—to say the least—be taken seriously.

With that fact in mind, I nevertheless believe that these opinions can—and should—be read less expansively than much of their literal language permits. My view rests in part on an instinctive sense that virtually all state tax incentives cannot *really* be unconstitutional. Such incentives, after all, constitute long-standing, familiar, and central features of every state's taxing system. Even more important, a somewhat narrower interpretation of the Court's opinions is, in my judgment, more consonant with accepted dormant Commerce Clause policy and the core rationales of the incentive decisions themselves. I recognize that one may question any effort to cabin the language of the Court's opinions, given that the Court itself has never displayed concern with their broad rationale. Like others,[71] however, I believe that the lethal swath an unrestrained reading of the Court's tax incentive opinions would cut across state tax regimes warrants a serious effort to offer a more moderate alternative.

2. The In-State Favoritism/State-Coercion Rationale

In my judgment, two core principles, which were identified at the outset of this discussion,[72] underlie the Court's state tax incentive decisions and should guide their proper interpretation. 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, courts should declare the tax unconstitutional.

All four of the Court's tax incentive decisions fall comfortably within this 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-

70. *Boston Stock Exchange*, *Westinghouse*, and *New Energy* were unanimous decisions, and the sole dissent in *Bacchus* rested exclusively on the ground that the Commerce Clause was inapplicable because the Twenty-first Amendment removed Commerce Clause restraints from state regulation and taxation of intoxicating liquors.

71. *See* Philip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 VAND. L. REV. 879, 928-37 (1986) (expressing concern that a broad interpretation of the Court's tax incentive opinions would invalidate a great majority of state tax incentives).

72. *See supra* notes 8-12 and accompanying text.

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 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.

That each of these cases comes out the same way under the in-state-favoritism/state-coercion approach reveals that it provides no panacea for state taxing authorities. Indeed, many tax incentives will fail to survive scrutiny under this reading of the Court's tax incentive decisions. At least one significant category of tax incentives, however, should 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. In my judgment, such incentives neither favor in-state over out-of-state investment (except in a sense that should be constitutionally irrelevant) nor do they 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 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."[73] 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 con-

73. Freeman v. Hewit, 329 U.S. 249, 256 (1946); *see also* Armco, Inc. v. Hardesty, 467 U.S. 638, 644-45 (1984) (noting the "shifting complexities" of the various state tax codes).

struction 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.

Moreover, insofar as the 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.[74] 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 commerce intrastate."[75] 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."[76] 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

74. *See generally* Walter Hellerstein, *Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation*, 87 MICH. L. REV. 138 (1988).

75. Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995).

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

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 latter, but not the former, reflects a use of the taxing power to coerce in-state business activity. In other words, there is a constitutionally significant difference between telling a taxpayer that it will decrease its after-tax cost of doing business in a state by engaging in particular activity in the state and telling a taxpayer that it will not increase its after-tax cost of doing business by doing business in the state.

a. Problems With the In-State-Favoritism / State-Coercion Rationale

I recognize that the suggested reading of the Court's tax incentive decisions is not above criticism, and that one may question whether the limiting principles suggested above are intellectually defensible. Two major objections come readily to mind. First, one can argue that there is no basis in the Court's decisions for distinguishing tax incentives involving invitations to engage in additional in-state activity from tax incentives that utilize "existing" tax liability to coerce in-state activity. In my view, however, the Court's own language supports the coercion-based analysis offered above. The Court has declared that states may "structur[e] their tax systems to encourage the growth and development of intrastate commerce and industry."[77] What a state may not do, by contrast, is to "us[e] its power to tax an in-state operation as a *means of 'requiring [other] business operations* to be performed in the home State.' "[78] The coercion-centered analysis, I believe, simultaneously responds to these twin commands of the high Court.

The suggested distinction between coercive and noncoercive tax incentives also finds support in the Court's recent decision in *Camps/Newfound Owatonna, Inc. v. Town of Harrison.*[79] In *Camps/Newfound*, the Court held that a Maine property tax exemption limited to charitable institutions that served mostly state residents discriminated against interstate

77. Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 336 (1977).
78. *Id.* (emphasis added).
79. 117 S. Ct. 1590 (1997).

commerce in violation of the Commerce Clause.[80] In so holding, the Court addressed the taxing authority's contention that the exemption should be sustained because it was no different in substance from discriminatory subsidies to which the Court had given its general approval in other cases.[81] In rejecting that argument, the Court reiterated the point it had made on two previous occasions:

> The 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.* Direct subsidization of domestic industry does not ordinarily run afoul of that prohibition; discriminatory taxation . . . does.[82]

By reaffirming its view that there is a significant constitutional distinction between taxes, which are generally regarded as coercive, and subsidies, which are not, the Court lends weight to the constitutional basis for the distinction articulated above between coercive and noncoercive state tax incentives.

Second, one might say that there is no functional difference between the "carrot" of offering relief from additional tax liability attributable to activity in which the state is inviting the taxpayer to engage and the "stick" of threatening maximization of existing tax liability attributable to activity in which the taxpayer already is engaged. For example, if one's ex ante assumption is that the taxpayer has engaged in none of the activity that gives rise to tax liability in cases like *Boston Stock Exchange*, *Bacchus*, *Westinghouse*, or *New Energy*, the analysis suggested above ought to dictate a different result in those cases. For example, if the taxpayer in *Boston Stock Exchange* was contemplating the sale of stock with transfer through a non-New York agent, or if the taxpayers in *Bacchus* and *New Energy* had never made any taxable wholesale liquor sales in Hawaii or taxable motor fuel sales in Ohio, or if the taxpayer in *Westinghouse* had not previously engaged in income-producing activity in New York, then one could articulate the state's appeal to the taxpayers in those cases in the following terms:

80. *Id.* at 1606.

81. For example, in *New Energy Co. v. Limbach*, 486 U.S. 269, 278 (1988), the Court declared that "[d]irect subsidization of domestic industry does not ordinarily run afoul of" the Commerce Clause prohibition barring taxes that discriminate against interstate commerce. And in *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 199 n.15 (1994), the Court repeated that observation.

82. *Camps/Newfound*, 117 S. Ct. at 1606 (quoting *New Energy*, 486 U.S. at 278).

"Come to our state and we will not saddle you with any additional tax burdens or at least not with the same tax burdens that we would ordinarily impose upon taxpayers engaging in such activity. Moreover, should you refuse our invitation, nothing will happen to your tax bill—at least nothing that depends on our taxing regime." This, of course, is the state position that has already been characterized as not "coercing" in-state activity, because the taxpayer was not already subject to the state's tax power. Thus, the argument may prove too much, by vindicating the very taxing regimes the Court struck down in its tax incentive decisions.

Put another way, the distinction between selectively forgiving taxes otherwise due if a taxpayer engages in in-state activity and disclaiming the right to impose any taxes on a "virgin" tax base a state is seeking to attract may be a distinction that turns entirely on whether a particular taxpayer has previously engaged in some taxable activity in the state. This may be too thin a distinction to carry the constitutional weight I am asking it to bear.

Although this line of criticism has some merit, and should and does enter into the analysis of the constitutionality of particular tax incentives,[83] it should be rejected as a blanket objection to the proposed approach because it ignores and distorts the real-world context in which tax incentives operate and, therefore, must be evaluated.[84] It is theoretically possible that a generally coercive tax incentive may, as to a particular taxpayer, be noncoercive and that a generally noncoercive tax incentive may, as to a particular taxpayer, be coercive. But these exceptions should not be permitted to swallow the rule, which ought to reflect the expected impact of the tax incentive on most taxpayers.

In short, the determination of whether a tax incentive is coercive should depend on its "practical or economic effect"[85] and on "economic realities."[86] To let the analysis turn on the

83. *See infra* Part IV (discussing specific implications of state tax incentives).

84. It is a central tenet of the Court's contemporary Commerce Clause jurisprudence that the validity of state taxes should be determined on the basis of their practical economic impact. *See, e.g.*, Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 288-89 (1977) (rejecting the idea that a state tax on the "priviledge of doing business" is per se unconstitutional because no economic consequence necessarily follows from the use of those words).

85. Goldberg v. Sweet, 488 U.S. 252, 262 (1989).

86. American Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266, 295 (1987)

remote possibility that a generally coercive tax incentive may be noncoercive in a few instances or that a generally noncoercive tax incentive may be coercive on occasion would allow the tail to wag the dog. It also would defeat the notion that "commerce among the states is not a technical legal conception, but a practical one, drawn from the course of business."[87]

In the end, I remain convinced that there is something to the distinction delineated above. Perhaps it is best captured by focusing on the nature of the constitutional *injury* alleged in the two different contexts. In the situation addressed by the Court in its tax incentive decisions, the alleged injury is the greater tax that the taxpayer will pay *in the taxing state* if it fails to engage in the targeted activity within the state, but rather conducts that activity in other states. When, on the other hand, there is no preexisting tax base that the state is offering to reduce (but rather only a potential tax base that the state proposes to tax at lower than ordinary rates or not at all), the alleged injury is the greater tax the taxpayer will have to pay *in other states*, based on the presumed existence of a tax on the targeted activity in such states. I know of no principle, however, that requires remediation of this sort of "injury" under the dormant Commerce Clause.[88]

(quoting *Complete Auto Transit*, 430 U.S. at 279).

87. Swift & Co. v. United States, 196 U.S. 375, 398 (1905).

88. This point is reinforced by considerations of causation. The taxpayer who challenges a tax incentive on the ground that its choice to engage in activity outside the incentive-granting state has a tax cost (in the form of foregone reduction of tax liability) within that state is complaining of an identifiable injury caused by the state's taxing regime. It therefore is stating a claim that falls within familiar boundaries—the defendant has caused it injury by denying it a right, the alleged right to a tax benefit for engaging in certain activity irrespective of the situs of such activity. By contrast, the taxpayer who challenges a tax incentive on the ground that its choice to engage in activity outside the incentive-granting state has a tax cost based on the assumption that it will pay taxes in other states is not complaining of an identifiable injury caused by the incentive-granting state's tax regime. Rather it is complaining of an injury allegedly caused by an actor other than the defendant. *Cf.* Tatarowicz & Mims-Velarde, *supra* note 71, at 937 (noting the difficulty of arguing that a state offering the incentive is burdening the party who chooses to also operate in a non-incentive state).

As a practical matter, this explains why a challenge to a state tax incentive that does not involve a claim of a right to a reduction of existing tax liability is unlikely to be successful. Consider a taxpayer who wishes to challenge a State A real property tax exemption for new construction in State A. Assume that the taxpayer has a preexisting taxable facility in State A and has just constructed a new, taxable facility in State B, which would have qualified for the exemption if constructed in State A. Since State A has not offered anyone a *reduction* in existing property taxes for constructing a new facility in State

Accordingly, the line between coercive and noncoercive tax incentives is meaningful and comports with longstanding principles of the Court's dormant Commerce Clause jurisprudence. In my view, analysis of tax incentives built on this distinction thus makes far more sense than a free-wheeling doctrine based only on the vague admonition that a state may not "foreclose[] tax-neutral decisions."[89]

IV. STATE TAX INCENTIVES AS STATE TAX DISCRIMINATION: SPECIFIC IMPLICATIONS

The question remains as to how the existing pattern of state and local tax incentives fares under the modes of analysis identified above. The final section of the Article assesses the constitutionality of various types of state tax within that analytical framework.

A. INCOME TAX INCENTIVES

1. Credits

The most common form of state tax incentive in this country is the income tax credit. As the litany of income tax credits described above indicates,[90] virtually all such credits tie the tax benefit offered by the state to specific in-state activity, whether it be the investment in in-state property, the hiring of in-state employees, or the expansion of in-state facilities. Accordingly, under the broadest reading of the Court's state tax incentive decisions, these credits cannot survive scrutiny because they fail the test of strict "tax neutrality" that the Court articulated in *Boston Stock Exchange* and its progeny.[91]

A, a court is unlikely to find that the taxpayer has stated a cause of action against State A under the Commerce Clause based on the fact that, prior to State A's offering of the tax exemption, the taxpayer engaged in taxable activity in State A. Moreover, the taxpayer's State A tax liability clearly was unaffected by the fact that the facility was constructed in State B. Indeed, insofar as there is any substance to the taxpayer's complaint to State A about unfair treatment vis-à-vis other State A taxpayers who have constructed new facilities in State A, the claim would appear to implicate Equal Protection rather than Commerce Clause concerns, because it involves a tax classification differentiating two forms of *intrastate* activity.

89. Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 331 (1977).

90. *See supra* notes 49-59 and accompanying text.

91. *See supra* Part II (discussing the Court's analysis of four tax incentive schemes); W. Eugene Seago & Wayne M. Schell, *Tax Credits and the Commerce Clause After* Westinghouse Electric Corporation, 3 J. STATE TAX'N 101, 111-12 (1984) (noting the success of taxpayer challenges to state tax credits);

State income tax credits similarly fail to pass muster under the narrower reading of the Court's tax incentive decisions I have offered above. Such credits violate the two principles that I have identified as central to the Commerce Clause analysis of the validity of state tax incentives: first, they favor in-state over out-of-state activity because income tax credits are almost invariably confined to the former; second, they implicate the coercive power of the state, because the taxpayer can reduce its state tax bill only by engaging in in-state activity.

2. Deductions

Income tax deductions limited (or granted on more favorable terms) to in-state as compared to out-of-state activities are functionally indistinguishable from income tax credits confined to in-state activities.[92] They therefore stand or fall according to the analysis set forth above.

A Wisconsin controversy over income tax deductions restricted to in-state property is illustrative. In keeping with its general conformity to the Internal Revenue Code in determining taxable income, Wisconsin has adopted the federal depreciation rules. In particular, the Wisconsin statutes permitted depreciation deductions for property located in Wisconsin to be taken

---

Joel Michael, *The Constitutionality of Minnesota's Business Tax Credits After* Westinghouse Electric Corp., 4 J. STATE TAX'N 163, 170-79 (1985) (analyzing the impact of *Westinghouse* on various Minnesota tax incentive cases). Many state tax credits are in fact limited to qualifying activities that take place in particular locations within a state (for example, enterprise zones), and it might be argued that such credits do not discriminate against interstate commerce because they deny tax benefits to in-state as well as out-of-state activity that is not conducted within the specified in-state location. This argument, however, cannot be maintained in light of cases holding that discrimination against interstate commerce is not rendered constitutionally acceptable by the fact that some intrastate commerce is subject to the same discrimination that is visited upon interstate commerce. *See* C & A Carbone, Inc. v. Town of Clarkstown, 114 S. Ct. 1677, 1682 (1994) (finding ordinance discriminates if it disfavors certain in-town and in-state waste processors); Dean Milk Co. v. City of Madison, 340 U.S. 349 (1951) (finding it immaterial that city ordinance disfavored out of town milk pasturizers as well as those involved in interstate commerce); *cf.* United Bldg. and Constr. Trades Council v. Mayor and Council of Camden, 465 U.S. 208 (1984) (finding city affirmative action ordinance for city construction projects subject to challenge under the Privileges and Immunities Clause). As the Court declared in *Maryland v. Louisiana*, 451 U.S. 725, 760 (1981), "We need not know how unequal the [t]ax is before concluding that it unconstitutionally discriminates."

92. I recognize, of course, that for purposes other than those under consideration here, there may be significant differences between deductions and credits (for example, their impact on the progressivity of a tax).

according to the favorable federal Accelerated Cost Recovery System (ACRS)[93] applicable to business-investment property. For the tax years in question, however, accelerated depreciation was not available for property located outside Wisconsin; instead, such property had to be depreciated according to the slower (and, therefore, less favorable) methods provided by an earlier version of federal law.[94]

The limitation of ACRS depreciation to in-state property might well be viewed as designed "to encourage the growth and development of intrastate commerce and industry."[95] Relying on *Boston Stock Exchange* and *Westinghouse*, however, the Wisconsin Tax Appeals Commission concluded that providing lower effective income tax rates to taxpayers who made in-state rather than out-of-state investments violated the Commerce Clause prohibition against discriminatory taxation.[96] The Commission found a "clear parallel"[97] to the discrimination the Court condemned in *Westinghouse* because:

> the Wisconsin depreciation deduction statutes at issue are obviously "designed to have discriminatory economic effects" on corporations locating depreciable property outside the state by taxing such corporations more heavily than those locating such property in the state.[98]

The favorable depreciation deduction for investment in Wisconsin property would likewise fail to pass muster under the more focused reading of the Court's state tax incentive decisions delineated above. The Wisconsin depreciation deduction violated both guiding principles that I believe should govern Commerce Clause analysis of the validity of state tax incentives: it favored in-state over out-of-state activity, and it implicated the coercive power of the state, because the taxpayer could obtain the maximum reduction in its Wisconsin tax bill only by engaging in in-state activity.

---

93. *See* I.R.C. § 168 (1994).

94. *See* I.R.C. § 167 (1988).

95. Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 336 (1977).

96. *See* Beatrice Cheese, Inc. v. Wisconsin Dep't of Revenue, (Wis. Tax Appeals Comm'n Feb. 24, 1993) [1990-93 Transfer Binder] Wis. Tax Rep. (CCH) ¶ 203-396 (finding a violation of the Commerce Clause by two Wisconsin statutes outlining approved corporate deductions).

97. *Id.*

98. *Id.* (quoting Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 406-07 (1984)).

3. Apportionment Formulas

There is one category of income tax incentives that seems to enjoy smooth sailing under the Court's precedents, although it is not obvious why this should be so.[99] Most states employ a three-factor formula based on property, payroll, and sales to apportion income among the states for tax purposes.[100] As originally conceived, the three-factor formula gave equal weight to each of these factors.[101] Under this mode of apportionment, a taxpayer's income is attributed to the state by a percentage determined by averaging the ratios of the taxpayer's property, payroll, and sales within the state to its property, payroll, and sales everywhere.[102] In recent years, however, there has been a decided trend toward adoption of apportionment formulas that give additional significance to the sales factor, often by doubling its weight in the determination of the apportionment percentage[103] and, in one instance, by eliminating the other factors altogether.[104]

The justification typically offered for giving additional weight to the sales factor in income tax apportionment formulas is that it will stimulate local economic development. Specifically, it encourages multistate taxpayers with sales spread throughout the nation to locate their property and payroll within the state on the theory that the extra weight given to the sales factor will reduce the percentage of the taxpayer's income assigned to the state. As a key economic advisor to the

99. *See* Michael, *supra* note 91, at 190-91 (discussing the confusion in determining standards to avoid discrimination in state tax credits).

100. *See* 1 Multistate Corp. Income Tax Guide (CCH), *supra* note 59, ¶ 146 (charting apportionment formulas used by various states).

101. *See* 1 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 8.06 (2d ed. 1993) (discussing the development of three-factor formula for determing the division of capital stock and net income taxes).

102. *See* UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT §§ 10-17, 7A U.L.A. 331, 349-55 (1985).

103. Under a three-factor formula with a double-weighted sales factor, a taxpayer's income is attributed to the state on the basis of a percentage determined by adding up the taxpayer's property factor, its payroll factor, and twice its sales factor and dividing the total by four. Of the 46 taxing authorities (45 states and the District of Columbia) with corporate net income taxes, roughly half now employ apportionment formulas that give more weight to the sales factor than to other apportionment factors. *See* 1 Multistate Corp. Income Tax Guide (CCH) *supra* note 59, ¶ 146.

104. *See* NEB. REV. STAT. §§ 77-2734.05, 77-2734.16 (1990).

Governor of Georgia observed in explaining the state's adoption of a double-weighted sales factor, the legislation:

> offer[s] economic incentives for business expansions and locations here....
>
> By promoting the activities of firms that have a physical presence—property and labor—in Georgia, [the legislation] should clearly have a stimulative effect.[105]

Something the Governor's advisor did not say, but which is equally true, is that giving additional weight to the sales factor increases the Georgia apportionment percentage for multistate taxpayers with sales spread throughout the nation (including Georgia) but whose property and payroll are located in other states.

The evils of an income tax apportionment formula that accords disproportionate weight to the sales factor were articulated by Justice Powell in his critique of the extreme version of such a formula—Iowa's single-factor sales formula—which ignores property and payroll altogether:

> Iowa's use of a single-factor sales formula—though facially neutral—operates as a tariff on goods manufactured in other States and as a subsidy to Iowa manufacturers selling their goods outside of Iowa....
>
> This surcharge on Iowa sales increases to the extent that a business' plant and labor force are located outside Iowa. It can be avoided altogether only by locating all property and payroll in Iowa; an Iowa manufacturer selling only in Iowa will never have any portion of income attributed to any other State. And to the extent that an Iowa manufacturer makes its sales in States other than Iowa, its overall state tax liability will be reduced. Assuming comparable tax rates, its liability to other States, in which sales constitute only one-third of the apportionment formula, will be far less than the amount of sales in Iowa, where sales are the exclusive mode of apportioning income. The effect of Iowa's formula, then, is to penalize out-of-state manufacturers for selling in Iowa and to subsidize Iowa manufacturers for selling in other States.[106]

---

105. Georgia Department of Revenue, *Passage of House Bill 50 Revamps Corporate Apportionment in Ga.*, GA. REVENUE Q., 1995, at 1 (quoting Dr. Henry Thomassen, economic advisor to Governor Zell Miller). Expressing similar sentiments, politicians and business groups in Massachusetts and Michigan have supported legislation to change their three-factor formulas with a double-weighted sales factor to a single-factor sales formula. *See Massachusetts: House Speaker Warms to Single Sales Factor*, 9 STATE TAX NOTES 895 (1995); *Massachusetts: Governor Launches Drive for Single Sales Factor*, 9 STATE TAX NOTES 748 (1995); *Michigan: Single Sales Factor Bill Creates Controversy*, 9 STATE TAX NOTES 896 (1995).

106. Moorman Mfg. Co. v. Bair, 437 U.S. 267, 283-84 (1978) (Powell, J., dissenting) (footnotes omitted).

Justice Powell's characterization of Iowa's taxing regime suggests that it should fail to pass muster under the Court's state tax incentive decisions. The Iowa scheme "forecloses tax-neutral decisions"[107] by offering a reduction in state tax liability to manufacturers who locate their property and payroll in Iowa. Furthermore, it "penalize[s] out-of-state manufacturers for selling in Iowa"[108] if they do not yield to Iowa's pressure to locate their property and payroll there.[109] Justice Powell's critique of the Iowa formula, however, was made *in dissent*.

Is the Court's rejection of Justice Powell's analysis in *Moorman Manufacturing Co. v. Bair*[110] incompatible with the Court's state tax incentive decisions? Not if they are given a proper reading. Rather, *Moorman* pointedly supports the central assertion advanced above: that the Court's tax incentive decisions neither should be nor can be applied by giving their broadest pronouncements a literal interpretation.

In *Moorman*, the Court declined the taxpayer's invitation to hold that Iowa, rather than states which had adopted the three-factor formula, "was necessarily at fault in a constitutional sense"[111] for causing the multiple taxation that allegedly resulted from the coexistence of the three-factor and single-factor formulas. Because there was no proof in the record as to precisely where the taxpayer's income was earned, the invalidation of the Iowa formula would have had to rest on "the importance of avoiding any risk of duplication in the taxable income of an interstate concern"[112] in light of the existing pattern of other states' taxing statutes. But the "only conceivable constitutional basis" for so holding "would be that the Commerce Clause prohibits any overlap in the computation of taxable income by the States."[113] Whatever the merits of such a rule as a matter of national policy, the Court concluded that the power to establish uniform rules for the division of income lay with Congress, not the Court, and it therefore refused to constitutionalize the three-factor formula.

107. Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 331 (1977).

108. *Moorman*, 437 U.S. at 284 (Powell, J., dissenting).

109. *Cf.* Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 400-01 (1984) (analyzing a New York statute and concluding that it "'provide[s] a positive incentive for increased business activity in New York State,' . . . but . . . penalizes increases in . . . activities in other States").

110. 437 U.S. 267 (1978).

111. *Id.* at 277.

112. *Id.*

113. *Id.* at 278.

Notwithstanding the legitimate criticisms that may be leveled against the Court's tolerance of Iowa's single-factor sales formula,[114] the formula does not offend the two core values that underlie the Court's state tax incentive decisions. First, a single-factor sales formula does not favor in-state over out-of-state activities,[115] unless one takes account of the taxing statutes of other states. As noted above, however, the Court generally has refused to consider other states' taxing regimes in determining the constitutionality of one state's taxing statute.[116] Moreover, insofar as the Court has taken account of the possibility of multiple taxation by ascertaining whether a tax passes the "internal consistency" test[117]—Iowa's taxing statute passes that standard with flying colors. If every state imposed a single-factor sales formula, the interstate enterprise would be subject to taxes no more burdensome than those imposed upon competing local enterprises. Rather, both intrastate and interstate firms would be subject to tax on 100%, but only 100%, of their income.

Second, a single-factor sales formula does not implicate the coercive power of the state by linking a reduction in the state's taxes to the conduct of in-state activity. Even assuming a taxpayer has existing income-producing activity within a state that has adopted a single-factor sales formula, the taxpayer's relocation of its property and payroll to the state offers no assurance that its in-state liability will be reduced. Indeed, if the taxpayer's in-state and out-of-state sales remain constant, shifting the taxpayer's property and payroll into the state will have no effect on the percentage of the taxpayer's income assigned to the state. The single-factor sales formula provides a lure to the multistate taxpayer not because it is coercive in any way, but because it capitalizes on the tax systems adopted by other states. This fact may render the single-factor sales formula problematic, but it does not render the formula unconstitutional under the Court's tax incentive decisions.

114. *See* 1 HELLERSTEIN & HELLERSTEIN, *supra* note 101, ¶ 8.8[2][b].

115. Indeed, Justice Powell himself recognized that Iowa's single-factor sales formula was "facially neutral." *Moorman*, 437 U.S. 267 at 283 (Powell, J., dissenting).

116. *See supra* note 73 and accompanying text.

117. *See supra* notes 74-75 and accompanying text.

B. PROPERTY TAX INCENTIVES

In contrast to income tax incentives, many property tax incentives will pass constitutional muster unless one reads the Court's state tax incentive opinions as condemning any tax provision that tilts business decisionmaking toward in-state investment. Under this criterion, property tax incentives would fail to survive scrutiny because they are tied to in-state investment and thus preclude business decisionmaking "solely on the basis of nontax criteria."[118] Under my more circumscribed view of the Court's decisions, however, property tax incentives should withstand Commerce Clause review if they do not favor in-state over out-of-state investment and do not implicate the coercive power of the state.

Property tax incentives that offer an exemption or abatement for new investment in the state (without collateral requirements discrete from the use or location of the property itself)[119] will survive scrutiny under these criteria. They do not favor in-state over out-of-state investment, if one assumes—as one ought to—that other states have adopted taxing regimes similar to the one in question.[120] Nor do they implicate the coercive power of the state, since a taxpayer does not reduce its otherwise applicable in-state property tax liability by acquiring property in the state. Rather, the taxpayer avoids only additional in-state tax liability by acquiring the property in question, just as it would if it acquired property in some other state.[121]

118. Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 331 (1977); *see supra* Part II.A (outlining the Court's holding and reasoning in *Boston Stock Exchange).*

119. *See infra* notes 124-125 and accompanying text (distinguishing between property tax incentives for new in-state investments with collateral requirements independent to the use or location of the property and incentives without such collateral requirements).

120. *See supra* notes 74-75 and accompanying text (providing two sources that support the notion that the taxing power of a state should not depend on taxing statutes of other states).

121. A recent Pennsylvania decision supports my thesis that property tax incentives of this nature will pass muster under the Commerce Clause. In *PPG Indus., Inc. v. Commonwealth*, 681 A.2d 824 (Pa. Commw. Ct. 1995), *aff'd*, 681 A.2d 832 (Pa. Commw. Ct. 1996), the court sustained a capital stock tax exemption limited to "the capital stock of entities organized for manufacturing, processing, research or development purposes which is invested in and actually and exclusively employed in carrying on manufacturing, processing, research or development within the state." *See also* PA. STAT. ANN. tit. 72, § 7602(a) (West Supp. 1996). The taxpayer, only some of whose manufacturing

This is not to suggest that all property tax incentives may be implemented with constitutional impunity. Property tax incentives will be in constitutional jeopardy within the adjudicative framework proposed above when they are tied to in-state activity *apart from investment in the property itself*. For example, property tax incentives limited to businesses that create a certain number of new jobs in the state or that make other investments of a certain magnitude in the state run afoul of the principle that a state may not limit tax incentives to those with a specified economic presence in the state[122]—at least when the economic presence does not constitute the very tax base that the state is seeking to attract. Such property tax incentives suffer from the infirmity that they link the tax benefit—exemption from local property taxes—to local activity that is discrete from the investment in the in-state property. Consequently, they violate the rule that a state may not use its taxing power to coerce taxpayers to engage in in-state activity.[123]

---

activities were carried on in the state, attacked the exemption on the ground that it discriminated against interstate commerce. Relying on *Westinghouse* and *Boston Stock Exchange*, the taxpayer argued that there is a discriminatory effect upon multistate corporations with a low proportion of manufacturing within Pennsylvania who are allegedly placed at a commercial disadvantage to those businesses which conduct more of their manufacturing within the state.

The court rejected this argument on the ground that the tax exemption was coterminous with the tax base and that there was no tax cost to the taxpayer in conducting economic activity across state lines. As the court observed:

> Once the capital stock is apportioned to . . . Pennsylvania, then a manufacturing exemption applies to exempt property within the state that is related to manufacturing within the state. Both the tax and the exemption is [sic] based on in-state property and does not affect out-of-state property. The fact that a proportion of the corporate headquarters is taxed is a result of locating the corporate headquarters within the Commonwealth, not on locating some or most of the manufacturing out-of-state. Regardless of the location of the manufacturing, nothing moving in interstate commerce is affected by the exemption.

PPG Indus. 681 A.2d at 830. The court's decision is significant in that it refuses to extend the teachings of cases like *Westinghouse* and *Boston Stock Exchange* beyond their proper limits.

122. *See* Maryland v. Louisiana, 451 U.S. 725, 756-57 (1981); Northwest Aerospace Training Corp. v. Commissioner of Revenue, (Minn. Tax Ct. Apr. 4, 1995) [2 Minn.] State Tax Rep. (CCH) ¶ 202-603.

123. The Court's decision in *Fulton Corp. v. Faulkner*, 116 S. Ct. 848 (1996), illustrates this distinction. In *Fulton*, the Court struck down a North Carolina intangible property tax that varied inversely with the corporation's presence in North Carolina. Prior to the levy's repeal in late 1995, North Carolina imposed an intangible property tax on, among other things, shares of

These tax incentives in effect say to the taxpayer that the state will refrain from imposing taxes on the taxpayer's property only if, in addition to acquiring property in the state, the taxpayer invests a certain amount of money in the state, or hires a certain number of employees in the state, or conducts operations of a certain size in the state. These incentives are distinguishable from those described earlier, which in effect say to the taxpayer that the state will not issue the taxpayer a property tax bill if it acquires in-state property that meets

---

stock owned by resident individuals and corporations and on shares of stock having a business situs in the state. The tax was imposed at the rate of 0.25% of the fair market value of the stock. The value of the stock assessed under the tax, however, was reduced by a percentage equal to the percentage of the corporation's income subject to tax in North Carolina. This percentage was determined by the familiar three-factor income apportionment formula of property, payroll, and sales.

Under this taxing regime, the stock of a corporation doing all of its business in North Carolina would be subject to no North Carolina's intangible property tax. Such a corporation would have a 100% income tax apportionment percentage which would, in turn, permit a 100% reduction in the value of the corporation's stock subject to tax in the hands of its shareholders. Conversely, the stock of a corporation doing no business in North Carolina would pay an intangible property tax measured by all of the stock's value. Such a corporation would have a zero percent income tax apportionment percentage which would, in turn, permit no reduction in the value of the corporation's stock subject to tax in the hands of its shareholders.

North Carolina's intangible tax regime plainly discriminated on its face against interstate commerce. As the Court observed in *Fulton*, "A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce." *Id.* at 855. Indeed, the only disputed question in the case was whether the facially discriminatory tax could be saved by the "compensatory" or "complementary" tax doctrine, *see generally* Walter Hellerstein, *Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination*, 39 TAX LAW. 405 (1986), and the Court held it could not.

For present purposes, *Fulton* is instructive in revealing the fault line between property tax incentives that will survive or fail to survive Commerce Clause scrutiny. A tax exemption available to any taxpayer which brings its property into the state will pass muster because it does not "discourage . . . corporations from plying their trades in interstate commerce," *Fulton*, 116 S. Ct. at 855; it merely lowers the cost of doing business in intrastate commerce, *see supra* note 121. By contrast, a tax exemption like that offered by North Carolina in *Fulton* will violate the Commerce Clause because it demands not only that the taxpayer bring its corporate stock into North Carolina (which any resident owner is deemed to do), but, in addition, that the corporation conduct its business in North Carolina. It is this collateral requirement—tying the exemption to the corporation's activity in state—that condemns the exemption under the Commerce Clause.

specified conditions regarding the use or location of the property itself.

It might be argued that the proposed distinction between defensible and indefensible property tax incentives is semantic and unworkable. Thus one might contend that property tax exemptions for property constructed within the state for specified purposes (for example, new manufacturing facilities) or in specified locations (for example, enterprise zones) require some in-state activity "apart from the investment in the property itself." It is true, of course, that property tax incentives that offer an exemption or abatement for new investment in the state invariably require some in-state activity "apart from the investment in the property itself," namely, that the investment be for the legislatively prescribed in-state purpose and no other. I nevertheless believe that there is a significant difference between relieving a taxpayer of a property tax burden ordinarily associated with ownership of property when the taxpayer acquires property under conditions that depend on the use or location of the property itself and relieving a taxpayer of a property tax burden ordinarily associated with ownership of property when the taxpayer acquires property under conditions that do not depend on the use or location of the property itself. In the former case, the taxpayer is required to engage in no in-state activity that fairly can be characterized as independent of the acquisition and disposition of the property. In the latter case, the taxpayer is required to engage in in-state activity that it might undertake even if it had never invested in the property (for example, creating a certain number of jobs in the state or making in-state investments of a certain magnitude).

The suggested distinction is hardly a stranger to the dormant Commerce Clause field. Indeed, both the Court and commentators have suggested the constitutional infirmity of "downstream restraints" placed on the recipient of a state-conferred benefit, including state subsidies.[124] There is no rea-

124. *See* South-Central Timber Dev., Inc. v. Wunnicke, 467 U.S. 82, 96-98 (1984); Foster-Fountain Packing Co. v. Haydel, 278 U.S. 1, 11 (1928); Dan T. Coenen, *Untangling the Market-Participant Exception to the Dormant Commerce Clauses*, 88 MICH. L. REV. 395, 463-73 (1989) (observing that the market-participant exception to the dormant Commerce Clause is confined to cases in which the state does not impose "downstream restraints" on in-state preferences); Walter Hellerstein, Hughes v. Oklahoma: *The Court, the Commerce Clause, and State Control of Natural Resources*, 1979 SUP. CT. REV. 51, 76-79 (arguing that state power to distribute state-owned resources does not extend to conditions on disposition that "independently burden" interstate commerce).

son why the same sort of restriction should not apply as forcefully to state-conferred tax breaks. To be sure, the "independent activity" standard will engender some difficulties in application. But this is hardly surprising because "it is an essential part of adjudication to draw distinctions, including fine ones, in the process of interpreting the Constitution."[125]

In any event, in the real world, property tax incentives seldom impose any conditions other than those linked to the use or location of the property itself.[126] Accordingly, they will rarely be vulnerable to the objection that they are exacting, as the price of relief from property taxes, the conduct of in-state activity independent of the investment in the property.

C. SALES AND SIMILAR TRANSACTION TAX INCENTIVES

Analysis of the constitutionality of sales and similar transaction tax incentives should track the analysis of property tax incentives offered above. If one reads the Court's state tax incentive opinions as condemning any tax provision that influences business decision-making, every sales or similar transaction tax incentive tied to the conduct of in-state activity lies in the constitutional danger zone.[127] In my view, however, sales and similar transaction tax incentives—like all other tax incentives—ought to survive Commerce Clause scrutiny if they do not favor in-state over out-of-state activity or implicate the coercive power of the state. Many sales and similar transaction tax incentives will pass this test.

For example, sales and use tax exemptions, credits, or refunds for property purchased for construction of new facilities in the state (or for use in connection with the relocation of a business in the state, or for use in an enterprise zone in the state)[128] are unobjectionable under these criteria. They do not favor in-state over out-of-state activity, unless one indulges the assumption—unwarranted under general principles of Commerce Clause analysis—that other states will tax the same

125. Walz v. Tax Comm'n, 397 U.S. 664, 679 (1970); *see, e.g.*, United States v. Lopez, 115 S. Ct. 1624 (1995) (striking down the Gun-Free School Zones Act by distinguishing it from statutes targeted to *economic* intrastate activities that substantially affect interstate commerce).

126. *See* [2 All States] State Tax Guide (CCH) *supra* note 63, ¶ 20-200 to 20-964 (listing all property taxes and exemptions by state).

127. See *supra* Part III.A (analyzing the Court's state tax incentive opinions).

128. *See generally* 1 Multistate Sales Tax Guide (CCH) *supra* note 59, ¶ 975 (listing state tax incentives for investment in industry).

transaction if it were effectuated in those states.[129] Nor do these tax breaks implicate the coercive power of the state. A taxpayer does not reduce its in-state tax liability by purchasing property for use within the state. It merely ensures that there will be no in-state tax cost from engaging in the transaction, just as there would be no in-state cost if it engaged in the transaction in some other state.

This does not mean that all sales and transaction tax incentives are constitutionally unobjectionable. The Court's decisions in *Boston Stock Exchange*, *Bacchus*, and *New Energy* establish that such incentives may well be vulnerable to constitutional attack. A number of sales and similar transaction tax incentives are constitutionally suspect under the analysis articulated above: specifically, those sales and similar transaction tax exemptions, credits, or refunds that are tied to in-state activity *apart from the in-state use of the property or services with respect to which the tax is imposed.*

Consider, for example, Arizona's law that grants a refund of transaction privilege taxes for motion picture companies that spend more than $1 million per year in the state to produce one or more motion pictures in the state;[130] or Arkansas' exemption from sales and use taxes of purchases of natural gas and electricity by steel mill operators that invest over $120 million in an Arkansas steel mill;[131] or Illinois' exemption from sales and use taxes of purchases of certain property used by businesses that make investments of at least $40 million in the state or that create a minimum of 200 jobs in the state;[132] or Nebraska's provision for refund of sales and use taxes for certain businesses that increase employment by two full-time employees in the state and that make specified minimum investments in the state;[133] or New Mexico's credits for sales or use taxes paid for purchases of qualified equipment incorporated into a manufacturing operation if the taxpayer employs one additional full-time employee in the state for every $250,000 in value of qualified equipment invested in the state;[134] or Oklahoma's exemption from sales and use taxes for purchases of tangible per-

129. *See supra* notes 73-75 and accompanying text (arguing that the taxing power of a state should not depend on the taxing statutes of other states).

130. *See* ARIZ. REV. STAT. ANN. § 42-1322.01 (Supp. 1995).

131. *See* ARK. CODE ANN. §§ 26-52-901 (Michie 1992, Supp. 1995).

132. *See* ILL. COMP. STAT. ANN. ch. 35, ¶ 120/1f (Smith-Hurd 1993).

133. *See* NEB. REV. STAT. § 77-27,188 (1996).

134. *See* N.M. STAT. ANN. § 7-9A-7.1 (Michie 1997).

sonal property by a qualified manufacturer for incorporation into a new manufacturing plant in the state if the total cost of construction exceeds $5 million and at least 100 jobs are created and maintained for at least 36 months in the state;[135] or South Dakota's provision for a credit or refund of contractors' excise taxes paid for construction of new or expanded manufacturing facilities and for sales and use taxes paid for the purchase of business equipment, if the project costs exceed $20 million.[136]

All of these sales and similar transaction tax incentives share a common constitutional defect: they link the tax benefit—reduction of state sales or similar transaction tax liability—to in-state activity that is independent of the use of the property or services with respect to which the tax is imposed. Consequently, they all offend the fundamental principle that a state may not use its taxing power to coerce taxpayers to engage in in-state activity. These tax incentives—like the income tax credits and deductions discussed above[137]—in effect tell the taxpayer that the state will release its grip on the taxpayer's tax dollars associated with transactions consummated in the state *only* if the taxpayer invests a certain amount of money in the state, or hires a certain number of employees in the state, or conducts operations of a certain size in the state.[138] Such in-

---

135. *See* OKLA. STAT. tit. 68, §1359(8) (Supp. 1997).

136. *See* S.D. CODIFIED LAWS ANN. § 10-45B-1 (Supp. 1996).

137. *See supra* Parts IV.A.1-2.

138. A recent Minnesota case is illustrative. In *Northwest Aerospace Training Corp. v. Commissioner of Revenue*, (Minn. Tax Ct. Apr. 4, 1995) [2 Minn.] St. Tax Rep. (CCH) ¶ 202-603, Minnesota provided an exemption from its sales and use tax on the receipts from the lease of airflight equipment to airline companies that paid the Minnesota flight property tax. The flight property tax is paid only by airline companies that make three or more flights per year into Minnesota. A lessor of flight equipment to federal agencies and miscellaneous third parties, who did not pay the flight property tax, challenged the exemption on the grounds that it discriminated against interstate commerce in violation of the Commerce Clause. In sustaining the objection, the court, citing *Boston Stock Exchange* and *Westinghouse*, declared:

> All United States domestic airlines who pay the Flight Property Tax are exempt from the sales tax when they rent airflight equipment. The Flight Property Tax is paid by all United States domestic airline companies who make three or more trips into or out of Minnesota during a calendar year. Payers of the Flight Property Tax typically have employees and equipment in Minnesota and lease airport facilities in Minnesota. . . .
>
> A United States domestic airline must pay Flight Property Tax to escape sales tax on rentals of airflight equipment. In effect, an airline is forced to establish an economic presence in Minnesota to es-

centives are therefore distinguishable from the benign form of transaction tax incentives described above which in effect say to the taxpayer that the state will not even seek to establish a grip on its tax dollars if the taxpayer consummates a transaction in the state, so long as the property or services with respect to which the tax is imposed are dedicated to the prescribed in-state use.

It might be argued, along the lines advanced above in the context of property tax incentives, that the distinction I have drawn between defensible and indefensible sales and similar transaction tax lacks substance. Thus, one might contend that there is no real distinction between, say, a sales tax exemption for property purchased for use in new facilities in the state and a sales tax exemption for property purchased in a facility that creates ten new jobs in a state. In each case, one may argue, there is a requirement that the taxpayer engage in some in-state activity apart from the taxable transaction itself, namely, that the property must be purchased for the defined purpose and for no other. Accordingly, the argument goes, the state in each case is exerting its tax power over the taxable transaction (i.e., the sale) to "coerce" the taxpayer to engage in some discrete in-state activity (use of the property in a new facility or use of the property in a facility that creates ten new jobs).

While it is true that there are conditions imposed upon tax-favored in-state transactions that I have characterized as constitutional apart from the naked act of making an in-state purchase, I believe, as explained in the context of property tax incentives, that the distinction I have drawn between the two categories of incentives is meaningful. There is a significant difference between relieving a taxpayer of a tax obligation ordinarily due upon a sale when the taxpayer puts the property sold to a particular in-state use or employs it in a particular in-state location and relieving a taxpayer of a tax obligation ordinarily due upon a sale when the taxpayer engages in in-state activity that does not depend on the use or location of the property sold. In the former case, the taxpayer is not required to engage in any in-state activity that fairly can be characterized as independent of the acquisition and disposition of the property itself. In the latter case, the taxpayer is required to en-

> cape the tax. A United States domestic airline which does not establish an economic presence in Minnesota is placed at a competitive disadvantage because it is forced to pay the [lessor's] lease rate for use of flight training equipment *and* a sales tax.

Id.

gage in in-state activity that it might undertake even if it had never purchased the property (for example, creating a certain number of jobs in the state or making in-state investments of a certain magnitude).

CONCLUSION

Whatever one may say about state tax incentives as a matter of social or economic policy, they plainly raise serious doubts as a matter of federal constitutional law. Perhaps this is not surprising, since the defining issues of public policy often emerge as questions of constitutional law. In this article, I have argued that many existing state tax incentives violate the Commerce Clause bar against discriminatory taxation of interstate state commerce because (1) they favor in-state over out-of-state activity and (2) they do so through the coercive machinery of the state. I have also suggested, however, that other state tax incentives that do not offend these two principles should survive Commerce Clause scrutiny, even though the language of some of the Court's tax incentive opinions can be read to condemn even these more benign incentives.

In any event, the burgeoning use of state and local tax incentives ensures that constitutional challenges will increasingly find their way into the courts. And when they do, courts may well end the "race to the bottom" or at least significantly reduce its pace.