Commerce Clause Restraints on State Tax Incentives

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INTRODUCTION

The states' provision of tax incentives to encourage industrial development within their borders has long been a feature of American political and economic life. 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 incentives is intense and important.[4] Arrayed against the persistent pleas that tax incentives are essential to a state's economic growth is a large body of evidence that incentives have

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[1] See Mark L. Nachbar et al., Income Taxes: State Tax Credits and Incentives, Tax Mgmt. (BNA) Multistate Tax Portfolio No. 1180 (1994).

[2] See, e.g., Letters to Editor, "Is Bay State's Harbor Tax Credit 'In for Rough Sledding,'?" State Tax Notes, March 24, 1997, p. 947 (discussing Massachusetts's recently enacted corporate excise tax credit for the federal harbor maintenance tax paid when shipping into or out of Massachusetts ports); 1995 Me. Laws ch. 368, § FFF-2, 1995 Me. Legis. Serv. 1020 (West), enacting 36 Me. Rev. Stat. Ann. §§ 6651-6659 (reimbursing taxpayers for local property taxes paid on new business machinery and equipment).

[3] See, e.g., 1993 Ala. Acts 93-851 (the so-called "Mercedes-Benz legislation"), discussed in Harriet Hanlon, Steel or Steal? Gulf States Challenges Alabama's Tax Incentives, State Tax Notes, Sept. 25, 1995, at 923.

[4] See Walter Hellerstein, Selected Issues in State Business Taxation, 39 Vand. L. Rev. 1033, 1034-38 (1986).

little effect on industrial location decisions.[5] In addition, the perceived economic benefits associated with such incentives---additional jobs and investment---must be weighed against the economic dangers they may engender---misallocation of resources and inefficient selection of beneficiaries.[6] Opposition to state tax incentives has spawned at least one proposal for a sweeping federal prohibition on their use.[7]

My purpose is not to enter this fray. Instead it is to consider the thorny legal questions that state tax incentives raise under the Federal Constitution. The most perplexing question arises under the dormant Commerce Clause: 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

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[5] See 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 of the literature, 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). But see Note, Problems with State Aid to New or Expanding Businesses, 58 S. Cal. L. Rev. 1019, 1024-25 (1985) (citing Fortune study showing practical importance of business incentives).

[6] See A Proposal to Prohibit Industrial Relocation Subsidies, 72 Tex. L. Rev. 669 (1994) (concluding that industrial relocation subsidies are undesirable from an economic and political standpoint); William Schweke et al., Bidding for Business 35 (1994) (noting the weight of scholarly opinion against using development incentives to attract new industry).

[7] See authorities cited supra note 6; see also Nathan Newman, Proposition 13 Meets the Internet: How State and Local Government Finances Are Becoming Roadkill on the Information Superhighway, State Tax Notes, Sept. 25, 1995, at 927, 933-34.

Supreme Court's 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."[8] The Court, however, has disapproved state tax measures designed to achieve that very objective on the ground that they "foreclose[] tax-neutral decisions"[9] and "'provid[e] a direct commercial advantage to local business.'"[10]

This paper 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 paper 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 paper then considers the constitutionality of a variety of state tax incentives within the suggested framework and also under alternative approaches that courts might utilize.

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

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

[9] Id. at 331.

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

Court's Commerce Clause jurisprudence from the very beginning.[11] 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.

State tax incentives, whether in the form of credits, exemptions, abatements, or other favorable treatment[12] typically share two features that render them suspect under the rule barring taxes that discriminate against interstate commerce. First, state tax incentives single out for favorable treatment

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[11] See Welton v. Missouri, 91 U.S. 275 (1876).

[12] This paper uses the term "tax incentive" to embrace any provision designed to encourage new or expanded business activity in the state, which (1) seeks to induce the taxpayer to take action it might not otherwise take if the tax were constructed according to generally accepted principles of sound tax policy (economic neutrality, administrability, and equity) and (2) is not an inherent part of the tax structure. Accordingly, the typical business expense deduction in an income tax or sale for resale exemption in a retail sales tax is not a "tax incentive" as that term is ordinarily understood because such a deduction or exemption is an essential structural feature of an income tax or a retail sales tax. If the deduction or exemption were granted on a more favorable basis to in-state than to out-of-state activity, however, it might lose its character as an essential structural feature of the tax and would therefore amount to a "tax incentive." See infra notes ___-___ and accompanying text.

activities, investments, or other actions that occur within the taxing state. For example, when South Carolina afforded BMW a sales tax exemption on all machinery acquired for its new multi-million dollar facility, it did so only because BMW located that facility in the state. Indeed, if state tax incentives were not limited to in-state activities, they would hardly be worthy of the appellation "state" tax incentive.

Second, state tax incentives, as integral components of the state's taxing apparatus, are intimately associated with the coercive machinery of the state. They therefore fall comfortably within the 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,"[13] it plainly applies to "action of that description <u>in connection with the State's regulation of interstate commerce</u>."[14] 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."[15]

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

The Court's treatment of state tax incentives suggests that

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[13] New Energy Co. v. Limbach, 486 U.S. 269, 278 (1988).

[14] <u>Id</u>. (emphasis in original).

[15] Oregon Waste Systems, Inc. v. Department of Environmental Quality, 114 S. Ct. 1345, 1354 n.9 (1994); <u>see also</u> Walling v. Michigan, 116 U.S. 446, 455 (1888) ("a discriminatory tax is, in effect, a regulation in restraint of commerce among the States").

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.[16] 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,[17] the Court considered a New York stock transfer tax that included an incentive designed to assist the New York brokerage industry. The transfer tax applied to "all sales, or agreements to sell, or memoranda of sales and all deliveries or transfers of shares or certificates of stock" in New York.[18] Because the "bulk of stock

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[16] See Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318 (1977); Bacchus Imports, Ltd. v. Dias, 468 U.S. 263 (1984); Westinghouse Elec. Corp. v. Tully, 466 U.S. 388 (1984); New Energy Co. of Indiana v. Limbach, 486 U.S. 269 (1988). During this time frame the Court has considered many other cases involving allegations of state tax discrimination, but none of them can fairly be characterized as involving measures deliberately designed to encourage business location or expansion within a state, even though they may have had the effect of encouraging in-state business operations. See, e.g., Oregon Waste Systems (striking down tax on in-state disposal of out-of-state waste that was higher than tax on in-state disposal of in-state waste); Associated Industries of Missouri v. Lohman, 511 U.S. 641 (1994) (striking down statewide use tax on goods purchased outside the state insofar as it exceeded sales tax on goods purchased within state); American Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266 (1987) (striking down flat highway taxes, which imposed higher per mile burden on interstate than upon intrastate trucks).

[17] 429 U.S. 318, 329 (1977).

[18] N.Y. Tax Law § 270.1 (McKinney 1966).

transfers . . . funnels through New York,"[19] New York's stock transfer tax applied to the lion's share of stock <u>transfers</u>, regardless of where the stock <u>sale</u> occurred. In order to encourage nonresident stock sellers and sellers of large blocks of stock to effectuate their sales through New York---rather than out-of-state---brokers, New York amended the statute to offer these sellers a tax break. In lieu of the tax that had previously applied uniformly to the transfer of securities through a New York stock transfer agent without regard to the situs of the sale, New York provided a reduced stock transfer tax for these sellers if they made their sales 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. Prior to the statute's amendment, the New York transfer tax was "neutral as to in-state and out-of-state sales"[20] 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"[21] because a seller's decision as to where to sell would no longer be made "<u>solely</u> on the basis of <u>nontax</u> criteria."[22] Instead, a seller would be induced to trade through a New York broker to reduce his or her transfer tax

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[19] <u>Boston Stock Exchange</u>, 429 U.S. at 327 n.19.

[20] <u>Id</u>. at 330.

[21] <u>Id</u>.

[22] <u>Id</u>. at 331 (emphasis supplied).

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."[23] Moreover, it had done so through the coercive use of its taxing authority. As the Court noted, "the State is using its power to tax an in-state operation as a means of requiring other business operations to be performed in the home State."[24]

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."[25] The Court did not explain, however, how states could effectively pursue this objective under the constraints of its reasoning in Boston Stock Exchange. If a state may not "use discriminatory taxes to assure that nonresidents direct their commerce to businesses within the State,"[26] and "discriminatory taxes" include those that reduce the effective tax rate when economic

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[23] Id. at 331 (emphasis supplied).

[24] Id. at 336.

[25] Id. at 336.

[26] Id. at 334-35.

activity is conducted inside rather than outside the state's borders, the effectiveness of tax policy as a means "to encourage the growth and development of intrastate commerce and industry" would be severely curtailed.[27]

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[27] The Court drew upon the reasoning of Boston Stock Exchange to invalidate a state tax in Maryland v. Louisiana, 451 U.S. 725 (1981). Maryland v. Louisiana is not a "tax incentive" case in the sense of the cases discussed in the text, however, because the provisions at issue were designed to insulate local business from the economic impact of a new exaction rather than to encourage new or expanded business activity in the state. The case nevertheless reinforces the teachings of the tax incentive cases that a state may not impose a tax on specified activities and then provide a credit against or reduction of the tax if the taxpayer engages in other local activities. In Maryland v. Louisiana, the Court held that Louisiana's First-Use Tax on natural gas, which applied to gas extracted from the Outer Continental Shelf (OCS) and subsequently "used" in Louisiana, unconstitutionally discriminated against interstate commerce because various credits and exclusions available only to local interests effectively immunized local interests from the tax. The Court's condemnation of the First-Use Tax credit against the state's severance tax, which is paid only by those who sever gas in Louisiana, would similarly condemn any such credit specifically designed to encourage economic development in the state:

> On its face, this credit favors those who both own OCS gas and engage in Louisiana production. The obvious economic effect of this Severance Tax Credit is to encourage natural gas owners involved in the production of OCS gas to invest in mineral exploration and development within Louisiana rather than to invest in further OCS development or in production in other States.

Id. at 757. By thus denouncing the levy's inducement for firms to shift business activities into the state, Maryland v. Louisiana (like the cases discussed in the text) casts a cloud over the whole range of state tax incentives.

B. Bacchus

In Bacchus Imports, Ltd. v. Dias,[28] 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."[29] The exemption for one of the beverages at issue---a brandy distilled from the root of an indigenous Hawaiian shrub---was "'to "encourage and promote the establishment of a new industry."'"[30] The exemption for the other---pineapple wine---was "'intended "to help" in stimulating "the local fruit wine industry."'"[31]

These lofty purposes, however, could not sanctify a tax incentive that unmistakably defied the prohibition against 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."[32] The means the state chose in Bacchus---taxing out-of-state but not in-state products---could not have

[28] 468 U.S. 263 (1984).

[29] Id. at 271.

[30] Id. at 270 (quoting In re Bacchus Imports, Ltd., 656 P.2d 724, 730 (Haw. 1982) (quoting S.L.H. 1960, c. 26, Sen. Stand. Comm. Rep. No. 87, in 1960 Senate Journal, at 224)).

[31] Id. (quoting In re Bacchus Imports, Ltd., 656 P.2d 724, 730 (Haw. 1982) (quoting S.L.H. 1976, c. 39, Sen. Stand. Comm. Rep. No. 408-76, in 1976 Senate Journal, at 1056)).

[32] Id.

been more offensive to the Commerce Clause's nondiscrimination principle. 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."[33]

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"[34] and even declared "that competition among the States for a share of interstate commerce is a central element of our free-trade policy."[35] It was also true, however, that "the Commerce Clause limits the manner in which the States may legitimately compete for interstate trade."[36] 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[37] may provide the most useful constitutional instruction about state tax incentives because the case involved the most common form of tax incentive, an income tax credit. Westinghouse arose out of New York's

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[33] Id. at 273.

[34] Id. at 271.

[35] Id. at 272.

[36] Id.

[37] 466 U.S. 388 (1984).

response to Congress's provision of tax incentives for American corporations to increase their exports. In 1971, Congress accorded preferred status to any entity that qualified as a "Domestic International Sales Corporation" or "DISC."[38] Under the federal tax laws, DISCs were not taxable on their income, and their shareholders were taxable only on 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.[39] On the other hand, if New York had sought to tax DISC income in full, it risked discouraging the manufacture of export goods within the state.[40]

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,'"[41] it adopted a partial credit for the parent against the tax on the income attributable to the DISC. The parent's maximum credit was determined by applying seventy percent of the parent's tax rate

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[38] 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). I.R.C. §§ 921-27 (1988).

[39] Westinghouse, 466 U.S. at 392.

[40] Id. at 392-93.

[41] 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).

to the parent's share of the DISC income, as apportioned to New York by the parent's business allocation percentage.[42] (In substance, this lowered the effective tax rate on DISC income taxable by New York to 30 percent of the otherwise applicable rate.) The maximum credit figure, however, was then adjusted to reflect the DISC's "New York export ratio"[43]---the ratio of the DISC's receipts from New York export shipments to its receipts from all export shipments. For example, if 100 percent of the DISC's exports were shipped from New York, the parent could claim the full credit and in effect pay 30 percent of the otherwise applicable rate on the DISC income. If, however, only 50 percent of the DISC's exports were shipped from New York, the parent could claim only one-half of the maximum credit and would pay taxes on DISC income at 65 percent of the applicable rate.

It was this latter aspect of the credit---its limitation by reference to the DISC's New York export ratio---that proved to be constitutionally fatal. The New York State Tax Commission contended that "multiplying the allowable credit by the New York export ratio . . . merely insures that the State is not allowing a parent corporation to claim a tax credit with respect to income

[42] 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).

[43] Westinghouse, 466 U.S. at 394.

that is not taxable by . . . New York."[44] The Court responded:

> This argument ignores the fact that the percentage of the DISC's accumulated income that is subject to New York franchise tax is determined by the parent's business allocation percentage, not by the export ratio. In computing the allowable credit, the statute requires the parent to factor in its business allocation percentage. This procedure alleviates the State's fears that it will be overly generous with its tax credit, for once the adjustment of multiplying the allowable DISC export credit by the parent's business allocation percentage has been accomplished, the tax credit has been fairly apportioned to apply only to the amount of the accumulated DISC income taxable to New York. From the standpoint of fair apportionment of the credit, the additional adjustment of the credit to reflect the DISC's New York export ratio is both inaccurate and duplicative.[45]

Although this analysis of the propriety of reducing the credit by reference to the DISC's New York export ratio may seem technical, it lies at the heart of Westinghouse and is critical to understanding Westinghouse's implications for the constitutionality of state income tax incentives. In effect, the Court was saying that New York was done providing the only kind of DISC income tax credit it could constitutionally offer when it lowered the effective tax rate on accumulated DISC income apportioned to New York.[46] In other words, the credit had to be

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[44] Id. at 399.

[45] Id. at 399 (citation omitted).

[46] New York had accomplished this objective by providing a credit against 70 percent of the tax otherwise due on the DISC income, thereby reducing the effective tax rate to 30 percent of the original rate.

apportioned to New York on the same basis that the DISC income was apportioned to New York, so that the effective New York tax rate on DISC income, though lower than the effective New York tax rate on other income, would not vary depending on the amount of the taxpayer's DISC activity in New York.

When New York took the step of limiting the credit by reference to the DISC's New York export ratio, it was tying the credit to New York activities in a manner that no longer corresponded evenhandedly to the DISC income being taxed. Rather, the effective New York tax rate on the DISC income being taxed (i.e., the DISC income apportioned to New York by the parent's business allocation percentage) varied directly with the extent of the taxpayer's New York DISC-related activities. The greater the percentage of a DISC's export shipments from New York, the greater the relative credit[47] for taxes paid upon DISC income within New York's tax power, and the lower the effective New York tax rate on such income. The lower the percentage of a DISC's export shipments from New York, the lower the relative credit for taxes paid upon DISC income within New York's tax power, and the higher effective New York tax rate on such income. New York thus

[47] One would expect the absolute amount of credit to increase as DISC-related activity in New York increased even under an evenhanded crediting scheme, such as described in the preceding paragraph, simply because more DISC-related income was taxable by New York and therefore there would be more DISC-related income tax available for the credit. The unacceptable feature of the New York scheme was that the proportional amount of credit---i.e., the credit allowable per dollar of DISC-income being taxed---increased or decreased according to the extent of DISC-related activity in New York.

released its grip on DISC income within its taxing power only to the extent that DISC-related activities were carried on in the state. It kept its grip firmly upon DISC income within its taxing power to the extent that DISC-related activities were carried on outside the state.

After examining the operation of New York's DISC credit scheme,[48] 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.'"[49] It was "irrelevant"[50] to the constitutional analysis that the earlier tax incentives the Court had considered "involved transactional taxes rather than taxes on

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

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

[50] Id. at 404.

general income,"[51] 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."[52] Nor did it matter "[w]hether the discriminatory tax diverts new business into the State or merely prevents current business from being diverted elsewhere";[53] it was "still a discriminatory tax that 'forecloses tax-neutral decisions.'"[54]

Moreover, the New York DISC credit had one particularly problematic effect not encountered in the Court's previous tax incentive cases: the credit decreased when the taxpayer increased its DISC-related activities elsewhere, even if the taxpayer's New York DISC-related activities remained unchanged.[55] The Court in Westinghouse described this as "the most pernicious effect of the credit scheme."[56] As the Court explained, "not only does the New York tax scheme 'provide a positive incentive for increased business activity in New York State,' but also it penalizes

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[51] Id.

[52] Id.

[53] Id. at 406.

[54] Id. (quoting Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 331 (1977)).

[55] This reduction in the credit resulted from the fact that the credit allowable per dollar of DISC income subject to tax varied according to relative amount of DISC-related activity in New York. See supra note 47.

[56] Westinghouse, 466 U.S. at 401 n.9.

increases in the DISC's shipping activities in other States."[57]

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,[58] 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."[59] The Court gave short shrift to the state's arguments in support of its disparate treatment of in-state and out-of-state products.

The Court had previously rejected a "reciprocity" defense to a statute that discriminated against out-of-state products,

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[57] Id. at 400-01 (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).

[58] 486 U.S. 269 (1988).

[59] Id. at 274.

observing that a state "may not use the threat of economic isolation as a weapon to force sister States to enter into even a desirable reciprocity agreement."[60] 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.[61] While "direct subsidization of domestic industry does not ordinarily run afoul of that prohibition; discriminatory taxation of out-of-state manufactures does."[62]

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."[63] After all, it is the rare state tax incentive that results in "tax-neutral decisions"[64] made "solely on the basis of nontax criteria."[65] Of course, the tax

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[60] Great Atlantic & Pacific Tea Co. v. Cottrell, 424 U.S. 366, 379 (1976) (quoted in New Energy, 486 U.S. at 274).

[61] New Energy, 486 U.S. at 278.

[62] Id.

[63] Problems with State Aid, supra note 5, at 1049.

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

[65] Id. at 331.

incentives struck down by the Court did not fail merely because they encouraged certain forms of business activity. The problem was that the challenged tax measures were not "neutral" as to in-state and out-of-state business activities.[66] But this refinement of the tax-neutrality principle to focus on where business activity occurs does not narrow its practical impact because almost every tax incentive is designed to induce business activity only within the taxing state.

Consider state income taxes. Almost no state income tax incentive---and there are hundreds of them across the country---meets the Court's seeming requirement of strict geographic neutrality. Alabama, for example, provides an income tax credit for new investment, but only if it occurs in Alabama;[67] Alaska provides an income tax credit for investment in gas processing and mineral development facilities, but only if they are built in Alaska;[68] Arizona provides an income tax credit for taxpayers that increase research activities in Arizona;[69] Arkansas provides an income tax credit for any motion picture production company that spends more than a specified amount producing films

[66] Cf. Boston Stock Exchange, 429 U.S. at 330 ("Prior to the 1968 amendment, the New York transfer tax was neutral as to in-state and out-of-state sales. . . . Section 270-a upset this equilibrium.").

[67] Ala. Code § 41-23-24(a) (1991).

[68] Alaska Stat. § 43.20.042 (1990).

[69] Ariz. Rev. Stat. Ann. § 43-1168 (Supp. 1993).

in Arkansas;[70] California provides an income tax credit for qualified equipment placed in service in California;[71] Colorado provides an income tax credit for investment in qualifying Colorado property;[72] Connecticut provides an income tax credit for investing in certain new manufacturing facilities in Connecticut;[73] Delaware provides an income tax credit for investing in qualified new business facilities in Delaware;[74] Florida provides an income tax credit for investments in Florida export finance corporations;[75] Georgia provides an income tax credit for taxpayers that increase employment by ten or more in designated counties in Georgia.[76] The list goes on and on.[77]

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

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[70] Ark. Code Ann § 26-4-206 (1992).

[71] Cal. Rev. & Tax. Code § 23649 (West Supp. 1994).

[72] Colo. Rev. Stat. § 39-22-507.6 (Supp. 1992).

[73] Conn. Gen. Stat. Ann. § 12-217e (West 1993).

[74] Del. Code Ann. tit. 30, § 2011(a) (1985).

[75] Fla. Stat. Ann. § 220.188 (Harrison 1990).

[76] Ga. Code Ann. § 48-7-40(e) (Supp. 1994).

[77] One could continue to proceed alphabetically through the states with similar examples. See [1] Multistate Corporate Income Tax Guide (CCH) ¶ 180 (1994); Nachbar et al., supra note 1.

business into the State."[78] 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."[79]

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 in the state.[80] Similarly, a number of states provide property tax incentives for new or expanded facilities in the state.[81] Given the near universality of state sales taxation in this country,[82] and the true universality of

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[78] Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 406 (1984).

[79] New Energy Co. v. Limbach, 486 U.S. 269, 274 (1988).

[80] <u>See generally</u> [1] Multistate Sales Tax Guide (CCH) ¶ 975 (1994).

[81] See [2 All States] State Tax Guide (CCH) ¶ 20-200 et seq. (1994).

[82] Forty-five states and the District of Columbia impose a retail sales tax. [2 All States] State Tax Guide (CCH) ¶ 60-100 (1995).

local property taxation, sales or property tax 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[83] by inducing resources to be allocated among the states on the basis of tax rather than nontax criteria.

A. Alternative Readings 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,[84] exemptions,[85] and

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

[84] Boston Stock Exchange, 429 U.S. 318, discussed supra Part II(A).

credits.[86] 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).[87] 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 issue in any one of the Court's four state tax incentive decisions.[88] 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,

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[85] Bacchus Imports, Ltd. v. Dias, 468 U.S. 263 (1984), discussed supra Part II(B).

[86] Westinghouse, 466 U.S. 388, discussed supra Part II(C); New Energy Co. v. Limbach, 486 U.S. 269 (1988), discussed supra Part II(D).

[87] See Walter Hellerstein, Justice Scalia and the Commerce Clause: Reflections of a State Tax Lawyer, 12 Cardozo L. Rev. 1763 (1991).

[88] 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.

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,[89] 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.

There is another justification for heading toward a middle-ground position: a number of Justices have indicated that the Court's broadest pronouncements should not be read for all they might be worth. Justice Stevens, for example, wrote the Court's opinion in West Lynn Creamery, Inc. v. Healy,[90] in which the Court invalidated a business development "tax-rebate" and broadly reaffirmed Bacchus. Yet in Hughes v. Alexandria Scrap Corp.,[91] Justice Stevens declared that:

> [I]n my judgment, [the Commerce] Clause [does not] inhibit a State's power to experiment with different methods of

[89] See Philip M. Tatarowicz and Rebecca R. Mims-Velarde, An Analytical Approach to State Tax Discrimination Under the Commerce Clause, 39 Vand. L. Rev. 879, 928-37 (1986).

[90] 114 S. Ct. 2203 (1994).

[91] 426 U.S. 794 (1976).

> encouraging local industry. Whether the encouragement takes the form of a cash subsidy, a tax credit or a special privilege intended to attract investment capital, it should not be characterized as a "burden on commerce."[92]

Similarly, Chief Justice Rehnquist---who joined the Court's opinions in all of the Court's tax incentive cases---has suggested that at least in some contexts "tax breaks" may be treated like subsidies for purposes of the dormant Commerce Clause.[93] If Justices of the Court who have written and joined the Court's key opinions in this field believe that those opinions permit at least some varieties of business-incentive tax breaks, then it is worthwhile to consider an interpretation of its opinions that would countenance at least some state tax incentives. The more difficult question concerns what forms of tax relief constitute permissible means of attracting and retaining local business operations.

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

In my judgment, two core principles, which were identified at the outset of this discussion,[94] underlie the Court's state

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[92] Id. at 816 (Stevens, J., concurring) (emphasis supplied).

[93] Chemical Waste Management, Inc. v. Hunt, 504 U.S. 334, 349-52 (1992) (Rehnquist, C.J., dissenting). Justices Scalia and Thomas also can be expected to avoid sweeping invalidation of business tax incentives unlike those involved in the Court's earlier decisions, given their openly declared skepticism regarding the dormant Commerce Clause and their avowed intention to honor only the strict holdings of the Court's past Commerce Clause decisions. See, e.g., Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 115 S. Ct. 1331, 1346 (1995) (Scalia, J., concurring in the judgment) (and cases cited therein).

[94] See supra notes 16-19 and accompanying text.

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-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.[95] At least one significant category of tax incentives, however, should escape invalidation: those tax incentives which 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

[95] I consider more systematically in Part IV infra what particular taxes will and will not survive scrutiny under this mode of analysis.

particular moment."[96] If a state's taxing statute must stand or fall on its own terms, a real property tax exemption for new construction in a state would pass muster because no additional tax liability could be presumed to result from new construction outside the state. By contrast, each of the tax measures at issue in the Court's tax incentive cases resulted in differential tax liability that was created entirely by the state's own taxing regime, depending on whether the taxpayer engaged in in-state or out-of-state activities.

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.[97] As the Court has explained, "[t]his test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with intrastate commerce."[98] A property

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

[97] See generally Walter Hellerstein, Is "Internal Consistency" Foolish: Reflections on An Emerging Commerce Clause Restraint on State Taxation, 87 Mich. L. Rev. 138 (1988).

[98] Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 115 S. Ct. 1331, 1338 (1995).

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."[99] By adopting such an exemption, the state is saying, in effect: "Come to our state and we will not saddle you with any additional property tax burdens. Moreover, should you choose not to accept our invitation, nothing will happen to your tax bill---at least nothing that depends on our taxing regime."

The state's posture in such circumstances stands in contrast to its posture in the tax incentive cases the Court has confronted in the past. In each of those cases the state was saying, in effect: "You are already subject to our taxing power because you have engaged in taxable activity in this state. If you would like to reduce those burdens, you may do so by directing additional business activity into this state. Should you decline our invitation, we will continue to exert our taxing

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

power over you as before, and your tax bill might even go up."[100]

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.

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. Beyond any doubts one may have regarding the underlying effort to identify limiting principles to the Court's tax incentive opinions,[101] one may question whether the limiting principles suggested above are intellectually defensible. Two major criticisms 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."[102] What a state may not do, by contrast, is to "us[e] its power to tax an in-state operation as a <u>means of requiring other business</u>

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[100] <u>See</u> <u>supra</u> notes 55-57 and accompanying text.

[101] <u>See</u> <u>supra</u> Part III(B)(1).

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

operations to be performed in the home State."[103] The coercion-centered analysis, I believe, simultaneously responds to these twin commands of the high Court.

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: "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

[103] Id.

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,[104] 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.[105] It is theoretically possible that a generally coercive tax incentive may, as to a

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[104] See infra Part IV.

[105] 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 (1977).

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.

Consider _Bacchus_. It is theoretically possible that some liquor wholesalers, with no previous sales in Hawaii, were induced by the exemption for locally-produced liquor to enter the Hawaii market to make exempt liquor sales. If that were the principal effect of the statute, it might well not offend the proposed constitutional standard. It seems much more likely, however, that the exemption affected few, if any, liquor wholesalers in this fashion. And obviously _no_ liquor wholesalers took _any_ account of the exemption to the extent they established operations in the state prior to its adoption. Once there, however, all these liquor wholesalers were subject to tax; they also were "arm-twisted" by the taxing scheme to channel their sales in the direction of locally-manufactured products. In these circumstances, it seems fair to say that the challenged Hawaii statute involved in essence an exemption from an _existing_ tax liability.

Consider, on the other hand, a sales tax exemption for equipment purchased in connection with the construction of a new in-state facility. It is theoretically true that a buyer potentially subject to a sales tax could purchase a large item of equipment and only then feel "coerced" by the availability of a tax exemption to build a factory to house the equipment in the would-be taxing state. If that were the principal effect of the statute, it would offend the proposed constitutional standard. But in the real world such a sequence of events is farfetched. In the usual case, the buyer will decide before it buys its equipment where the facility will be located and, hence, where the equipment will be used. Consequently, whatever influence the exemption exerts is almost certain to be felt before rather than after sales tax liability attaches. In these circumstances, it makes no sense to characterize the tax exemption as coercive; instead, as suggested above, the state simply offers the prospective buyer/developer an invitation to do business in the state, while threatening it with no adverse effects if it chooses not to do so.[106]

In short, the determination whether a tax incentive is coercive should depend on its "practical or economic effect"[107]

[106] In this connection, it is worth noting that sales or use tax liability ordinarily attaches, if it attaches at all, only in the state in which the property is ultimately used, in light of the virtually universal exemption from sales taxation of property purchased in one state for out-of-state use. 2 Jerome R. Hellerstein & Walter Hellerstein, State Taxation ¶ 18.02[1] (1992); see infra notes ___-___ and accompanying text. In other words, there is ordinarily no tax cost in State A associated with buying property in State A for use in State B; in such circumstances, State A will impose no sales tax, but State B will impose a use tax. See generally Hellerstein & Hellerstein, supra, ¶ 16.01.

[107] Goldberg v. Sweet, 488 U.S. 252, 262 (1989).

and on "'economic realities.'"[108] To let the analysis turn on the 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 "[c]ommerce among the states is not a technical legal conception, but a practical one, drawn from the course of business."[109]

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

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[108] American Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266, 295 (1987) (quoting Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977)).

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

the dormant Commerce Clause.[110]

For all these reasons, 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

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[110] 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 89, at 937.

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 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 it constructed a facility 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.

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."[111]

3. The Penalizing-Activity-in-Other-States Rationale

The scope of the Court's state tax incentive opinions might be limited in another, very different way. Two observers, motivated by the same concerns articulated above regarding the devastating impact that an unrestrained reading of the Court's tax incentive opinions would have on the existing pattern of state tax incentives,[112] have suggested that, "on closer examination,"[113] the opinions need not be read so broadly. In their view, "a state tax incentive that focuses exclusively on a taxpayer's in-state activities does not have the sort of negative impact on interstate commerce with which the commerce clause is concerned."[114] Rather, "the key to finding a tax incentive unconstitutionally discriminatory appears to be a reliance by the state tax provision on both a taxpayer's in-state and out-of-state activities in determining the taxpayer's effective tax rate."[115] Thus, the critical inquiry is whether the incentive

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

[112] Tatarowicz & Mims-Velarde, supra note 93, at 928, 931-32, and 935.

[113] Id. at 928.

[114] Id. at 928-29.

[115] Id. at 929.

creates "penalties for out-of-state activities."[116]

Under this approach, according to the authors, Boston Stock Exchange is a decision that rests on the ground that the tax incentive "tied the effective rate of tax not only to the New York activity with which the state identified the taxable moment, but also to whether another activity (i.e., sale on an exchange) took place in New York or in another state."[117] Similarly, Westinghouse is viewed as a case in which the unconstitutional evil was not the showing of favoritism toward in-state investment but rather the placement of "penalties for out-of-state activities."[118] Accordingly, it may be argued that "[t]here is no indication . . . that these cases require a state to offer incentives regardless of the state in which the desired activities occur; the cases indicate only that the effective tax rates must not be tied to out-of-state activities."[119]

While this analysis provides a basis for limiting the scope of the Court's tax incentive decisions, I believe that it is not as useful a mechanism for distinguishing constitutional from unconstitutional tax incentives as the coercion-based analysis suggested above. First, it fails to draw a meaningful line between a tax incentive that penalizes out-of-state activity and one that merely rewards in-state activity. For example, it is

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[116] Id. at 936.

[117] Id. at 930.

[118] Id. at 936.

[119] Id. at 933.

unclear why Boston Stock Exchange should be placed in the former category rather than the latter. New York, after all, was not trying to penalize those who utilized out-of-state brokers, but only to reward those who used in-state brokers. In these circumstances, it seems fair to say that New York's "state tax incentive . . . focuse[d] exclusively on a taxpayer's in-state activities."[120] The Court already has declared in no uncertain terms that the Commerce Clause brooks no distinction between laws that "benefit" in-staters and laws that "burden" out-of-staters.[121] In my judgment, this principle leaves no room for a rule that tries to distinguish instead between "rewards" and "penalties."

Second, and more significantly, the penalty-based analysis falters because it focuses on only one of the two core principles underlying dormant Commerce Clause restraints on discriminatory state taxation---whether the tax incentive favors in-state over out-of-state activities. It does not address the other critical aspect of the Court's dormant Commerce Clause jurisprudence---whether the incentive is effectuated by the coercive power of the state. In this respect, the proposed "penalty" analysis would fail to identify tax incentives that ought to be struck down. Thus the authors provide the following illustration of a tax incentive that, in their view, passes constitutional muster:

> For example, if an out-of-state business

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[120] Id. at 928-29.

[121] Bacchus Imports, Ltd. v. Dias, 468 U.S. 263, 273 (1984).

> investing one million dollars in a state is entitled to the same investment credit that an in-state business would receive if it likewise decided to invest one million dollars in the state, and no reduction in the credit results from out-of-state investment, then the credit does not have a negative discriminatory effect on protected commerce.[122]

I disagree. If the taxpayer is subject to state income tax, and thus within the coercive power of the state, and the opportunity to reduce that income tax is conditioned on making an in-state investment, it makes no difference that an in-state business would be treated in the same way or that the taxpayer's credit is not reduced (as it was in Westinghouse) by out-of-state investment. The critical point is that the state is using its coercive taxing power to skew an existing taxpayer's investment decision: the state will reduce the taxpayer's income tax liability only if it makes an in-state investment.

The fact that the in-state taxpayer's decision would be as skewed as the out-of-stater's decision does not rescue the incentive from constitutional condemnation. The Commerce Clause precludes discrimination against interstate commerce, not just discrimination against out-of-state taxpayers.[123] Nor does it make any difference that there may be no reduction in the credit should the taxpayer make an out-of-state investment. Although the

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[122] Id. at 936.

[123] Indeed, in Boston Stock Exchange, the tax incentive discriminated in favor of nonresident taxpayers as compared to similarly situated resident taxpayers, although, to be sure, in favor of only such nonresidents that engaged in specified in-state activity.

Court in Westinghouse indicated that "most pernicious effect of the credit scheme"[124] was that the credit declined as out-of-state activity increased, this was plainly not the only effect of the credit that the Court found objectionable. Rather, while the Court noted and repeated this feature of the credit,[125] the clear thrust of the opinion was that any provision that reduces the taxpayer's "effective [in-state] tax rate"[126] as the taxpayer engages in more in-state activity violates the Commerce Clause.

In short, despite my sympathy with efforts to limit the scope of the Court's state tax incentive decisions, I do not believe that either the decisions themselves, or the underlying purposes of the Commerce Clause, fairly support the proposition that "a state tax incentive that focuses exclusively on a taxpayer's in-state activities does not have the sort of negative impact on interstate commerce with which the commerce clause is concerned."[127]

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[124] Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 401 n.9 (1984).

[125] Id; see also id. at 400-01.

[126] Id. at 401 n.9.

[127] Tatarowicz & Mims-Velarde, supra note 89, at 928-29.

Notably, the reported state judicial and administrative decisions involving challenges to provisions that, in a loose sense, may be characterized as state tax incentives have tended to take a view of the Court's state tax incentive decisions that is much more like the position I have advanced above than the more restrictive "penalty" approach described in the text. See Sprint Communications Co. v. Kelly, 642 A.2d 106 (D.C. Ct. App.), cert. denied, 115 S. Ct. 294 (1994) (property tax exemption for personal property used by a telecommunications company to produce taxable gross receipts and sales tax exemption for property purchased by a telecommunications company for use in producing services subject to gross receipts tax discriminates against interstate commerce); Division of Alcoholic Beverages & Tobacco v. McKesson Corp., 524 So. 2d 1000 (Fla. 1988), rev'd on other grounds, 496 U.S. 18 (1990) (tax preference for alcoholic beverages made from citrus fruits and other agricultural products grown primarily, though not exclusively, within the state discriminates against interstate commerce); Delta Air Lines, Inc. v. Department of Revenue, 455 So. 2d 317 (Fla. 1984) (corporate income tax credit for fuel taxes limited to Florida-based air carriers discriminates against interstate commerce); Russell Stewart Oil Co. v. Department of Revenue, 529 N.E.2d 484 (Ill. 1988) (tax preference for gasohol made from products that were used by almost all in-state producers but not many out-of-state producers discriminates against interstate commerce); Comptroller of the Treasury v. Armco, Inc., 521 A.2d 785 (Md. Ct. Spec. App. 1987) (exemption from state corporate income tax for DISC dividends if at least 50 percent of the net taxable income of the DISC is subject to taxation in the state discriminates against interstate commerce); Burlington Northern, Inc. v. City of Superior, 388 N.W.2d 916 (Minn. 1986), cert. denied, 479 U.S. 1034 (1987) (exemption from occupation tax on iron ore dock operators for iron ore taxed under occupation tax on local mineral producers discriminates against interstate commerce); Archer Daniels Midland Co. v. State ex rel. Allen, 315 N.W.2d 597 (Minn. 1982) (tax reduction for gasohol produced in state discriminates against interstate commerce); Northwest Aerospace Training Corp. v. Commissioner of Revenue, No. 6523, Minn. Tax Ct., April 4, 1995, reprinted in [2 Minn.] St. Tax Rptr. (CCH) ¶ 202-603 (exemption for receipts from leases of flight equipment if lessees made three or more flights into the state discriminates against interstate commerce); Giant Indus. of Ariz., Inc. v. Taxation and Revenue Dep't, 796 P.2d 1138 (N.M. Ct. App. 1990) (gasoline excise tax deduction for ethanol-blended gasoline manufactured exclusively within the state discriminates against interstate commerce); American Tel. & Tel. Co. v. New York State Dep't of Taxation and Finance, 637 N.E.2d 257 (N.Y. 1994) (deduction for access charges paid by long-distance telephone companies to local telephone companies, which is reduced only for interstate long-distance companies by their state apportionment percentage, discriminates against interstate commerce); Wisconsin Dep't of Revenue v. NCR Corp., Nos. 92 CV 1516 and 92 CV 1525, Wis. Cir. Ct., Dane Cty., April 30, 1993, reprinted in [1990-93 Transfer Binder Wis.] St. Tax Rptr. (CCH) ¶ 203-412 (deduction for dividends received from subsidiaries limited to subsidiaries more than 50 percent of whose income was taxable by the state discriminates against interstate commerce); Beatrice Cheese, Inc. v. Wisconsin Dep't of Revenue, Wis. Tax

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 answer depends on the type of tax incentive at issue and the particular analytical construct that the court employs to evaluate it. This section of the paper assesses the constitutionality of various types of state tax incentives under both my and others' proposed frameworks for constitutional analysis.

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

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Appeals Comm'n, Nos. 91-I-100 through 91-I-102, Feb. 24, 1993, reprinted in [1990-93 Transfer Binder Wis.] St. Tax Rptr. (CCH) ¶ 203-396 (accelerated depreciation deduction limited to in-state property discriminates against interstate commerce); but see Archer Daniels Midland Co. v. State, 690 P.2d 177 (Colo. 1984) (gasoline tax reduction for certain gasohol that benefitted only in-state producers is a permissible incentive for development of fuel-grade alcohol industry) (post-Bacchus); Caterpillar, Inc. v. Department of Treasury, 488 N.W.2d 182 (Mich.), cert. denied, 113 S. Ct. 636 (1992) (deduction for capital acquisitions, which was limited by percentage of taxpayer's property and payroll in the state, is a legitimate incentive for encouragement of in-state business); Williams Cos. v. Director of Revenue, 799 S.W.2d 602 (Mo. 1990), cert. denied, 501 U.S. 1260 (1991) (restricting right to file consolidated state tax return to affiliated groups of corporations that derive more than 50 percent of their income from sources within the state does not discriminate against interstate commerce). The Sprint case is discussed infra note ___; the Northwest Aerospace case is discussed infra note ___; the AT&T case is discussed infra note ___; and the Beatrice case is discussed infra notes ___-__ and accompanying text.

described above indicates,[128] 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.[129]

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-

[128] See supra notes 67-77 and accompanying text.

[129] See supra Part II; W. Eugene Seago and Wayne M. Schell, Tax Credits and the Commerce Clause After Westinghouse Electric Corporation, 3 J. State Tax'n 101, 111-12 (1984); Joel Michael, The Constitutionality of Minnesota's Business Tax Credits After Westinghouse Electric Corp., 4 J. State Tax'n 163, 170-79 (1985). Many state tax credits are in fact limited to qualifying activities that take place in particular locations within a state (e.g., 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); Dean Milk Co. v. City of Madison, 340 U.S. 349 (1951); cf. United Bldg. and Constr. Trades Council v. Mayor and Council of Camden, 465 U.S. 208 (1984) (Privileges and Immunities Clause). As the Court declared in Maryland v. Louisiana, 451 U.S. 725, 760 (1981), "[w]e need not know how unequal the [t]ax is before concluding that it unconstitutionally discriminates."

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.[130]

Only if one adopts the view that state tax incentives for in-state activity are constitutional so long as they do not "penalize" out-of-state activity[131] (e.g., by raising the in-state tax bill when local activity remains constant but out-of-state activity increases[132]) can one persuasively defend the constitutionality of the vast majority of income tax credits in this country. Since most income tax credits merely reward in-state activity by reducing the taxpayer's income tax bill and do not impose a tax cost on out-of-state activity (aside from the

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[130] I note one qualification---albeit an extremely narrow one---of the rule set forth in the text. The presence of discrimination triggers a "virtually per se rule of invalidity." Oregon Waste Systems, Inc. v. Department of Environmental Quality, 114 S. Ct. 1345, 1351 (1994) (emphasis on "virtually" supplied); see also id. at 1350; Chemical Waste Management, Inc. v. Hunt, 504 U.S. 334, 344 n.6 (1992). It is thus open to states to argue that a given tax incentive is permissible, even though discriminatory, because it offers the only effectively available means of advancing a focused and compelling governmental interest. See Maine v. Taylor, 477 U.S. 131, 138, 144 (1986); New Energy Co. v. Limbach, 486 U.S. 269, 274 (1988). One could argue, for example, that a very limited and carefully tailored income tax credit designed to address extremely severe unemployment in a specifically targeted locale might meet this standard. See Schweke et al., supra note 6, at 45 ("[t]ax subsidies that result in increased employment in areas of relatively high unemployment may actually increase total local or national welfare"). In my view, however, this strict scrutiny test will be met only in the rarest of cases.

[131] See supra Part III(B)(3).

[132] As was the case in Westinghouse. See supra notes 55-57 and accompanying text.

opportunity cost of foregoing a reduction in in-state income tax liability), most income tax credits will survive scrutiny under this approach. For reasons set forth above, however, I do not believe that such a limited conception of Commerce Clause restraints on state tax incentives is warranted.[133] In particular, I do not see how credits for in-state activities can pass muster when the Court in Boston Stock Exchange struck down a tax precisely because it afforded a tax reduction for conducting business activity in the state.

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.[134] 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 according to the favorable federal

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[133] See supra notes 119-27 and accompanying text.

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

Accelerated Cost Recovery System (ACRS)[135] 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.[136]

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."[137] 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.[138] The Commission found a "clear parallel"[139] 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

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[135] I.R.C. § 168 (1988).

[136] I.R.C. § 167 (1988).

[137] Boston Stock Exchange v. State Tax Comm'n, 429 U.S. 318, 336 (1977).

[138] Beatrice Cheese, Inc. v. Wisconsin Dep't of Revenue, Wis. Tax Appeals Comm'n, Nos. 91-I-100 through 91-I-102, Feb. 24, 1993, reprinted in [1990-93 Transfer Binder Wis.] St. Tax Rptr. (CCH) ¶ 203-396.

[139] Id. at p. 15,706.

> corporations locating depreciable property outside the state by taxing such corporations more heavily than those locating such property in the state.[140]

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

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[140] Id. (quoting Westinghouse Elec. Co. v. Tully, 466 U.S. 388, 406-07 (1984)). In American Tel. & Tel. Co. v. New York State Dep't of Taxation and Finance, 637 N.E.2d 257 (N.Y. 1994), the court struck down New York's requirement that long-distance telephone companies apportion the deduction from their taxable gross receipts for access charges paid to local telephone companies in the same manner that they apportion their gross receipts for New York tax purposes. Long-distance carriers that are unable to account directly for their New York revenues are required to apportion their gross receipts based upon the ratio of their New York property to their total property. (See infra notes 150-54 and accompanying text for a description of state income tax apportionment formulas.) As a consequence, an interstate long-distance carrier, which owned property both within and without New York, would receive only a proportionate deduction for access charges paid to local telephone companies in the state whereas local long-distance carriers (providing phone service, say, between New York City and Albany) would receive a deduction for 100 percent of their access charges. The court observed that "the statute has the practical and real effect of treating differently long-distance carriers similarly situated in all respects except for the percentage of their property located within New York State," American Tel. & Tel., 637 N.E.2d at 259, and that it "plainly creates a direct commercial advantage to intrastate long-distance carriers." Id. If New York had permitted long-distance carriers to deduct all access charges, regardless of where incurred, plainly it would have been entitled to require the taxpayer to apportion the deduction to New York, just as the base was apportioned to New York. The vice in the statute was that the only deduction allowed was for in-state access charges. Hence, the state was clearly barred from requiring further apportionment, which reduced the deduction only for interstate carriers, and thereby effectively created a discriminatory tax incentive. Indeed, in this respect the case had the "most pernicious effect" of a state tax incentive identified in Westinghouse (466 U.S. at 401 n.9), because it penalized out-of-state activity: as a carrier expanded its investment in property outside New York, even if its activity in New York remained constant, its New York access fee deduction would decline.

delineated above. The Wisconsin depreciation deduction violated both guiding principles 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-state activity.

The Wisconsin depreciation scheme would pass muster only if one embraced the view that, so long as state tax incentives for in-state activity do not penalize out-of-state activity, they are constitutionally acceptable.[141] The Wisconsin depreciation scheme passes this test because a taxpayer's Wisconsin tax does not increase as a result of its investment in out-of-state property.

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.[142] Most states employ a three-factor formula based on property, payroll, and sales to apportion income among the states for tax purposes.[143] As originally conceived, the three-factor formula gave equal weight

[141] See supra Part III(B)(3).

[142] See Michael, supra note 129, at 190-91.

[143] [1] Multistate Corporate Income Tax Guide (CCH) ¶ 146 (1996).

to each of these factors.[144] 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.[145] 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[146] and, in one instance, by eliminating the other factors altogether.[147]

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

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[144] 1 Hellerstein & Hellerstein, supra note 106, at ¶ 8.06.

[145] See Uniform Division of Income for Tax Purposes Act §§ 10-17, 7A U.L.A. 331 (1985).

[146] 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. [1] Multistate Corporate Income Tax Guide (CCH) ¶ 146 (1996).

[147] Neb. Rev. Stat. §§ 77-2734.05, 77-2734.16 (1990).

assigned to the state.[148] As a key economic advisor to the Governor of Georgia recently 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."[149]

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

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[148] To be sure, the "reduction" may be relative rather than absolute, because the decrease in the apportionment percentage attributable to double-weighting of the sales factor may be more than offset by the increase in the apportionment percentage attributable to the larger property and payroll factors, if the taxing scheme has its intended effect of drawing property and payroll into the state. Such an absolute increase in the apportionment percentage, however, is likely to be offset by the reduction in the taxpayer's apportionment percentages in other states.

[149] Georgia Department of Revenue, Georgia Revenue Quarterly, Vol. 17, No. 1, at 1 (1995) (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, State Tax Notes, Sept. 25, 1995, at 895; Massachusetts: Governor Launches Drive for Single Sales Factor, State Tax Notes, Sept. 11, 1995, at 748; Michigan: Single Sales Factor Bill Creates Controversy, State Tax Notes, Sept. 25, 1995, at 896.

accords disproportionate weight to the sales factor, in the context of the widespread adoption of an equally-weighted three-factor formula, are not hard to discern. Indeed, they already have been described 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. Because 44 of the 45 other States which impose corporate income taxes use a three-factor formula involving property, payroll, and sales, Iowa's practice insures that out-of-state businesses selling in Iowa will have higher total tax payments than local businesses. This result follows from the fact that Iowa attributes to itself all of the income derived from sales in Iowa, while other taxing States---using the three-factor formula---are also taxing some portion of the same income through attribution to property or payroll in those States.[150]

Justice Powell went on to explain:

> 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

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

> 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.[151]

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"[152] 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"[153] if they do not yield to Iowa's pressure to locate their property and payroll there.[154] 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[155] 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

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[151] Id. at 284.

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

[153] Moorman, 437 U.S. at 284 (Powell, J., dissenting).

[154] Cf. Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 400-01 (1984).

[155] 437 U.S. 267 (1978).

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"[156] 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"[157] in light of the existing pattern of other states' taxing statutes. But the "only conceivable basis" for so holding "would be that the Commerce Clause prohibits any overlap in the computation of taxable income by the States."[158] 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.

Notwithstanding the legitimate criticisms that may be leveled against the Court's tolerance of Iowa's single-factor

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[156] Moorman, 437 U.S. at 277.

[157] Id.

[158] Id. at 278.

sales formula,[159] 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,[160] 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.[161] Moreover, insofar as the Court has taken account of the possibility of multiple taxation by ascertaining whether a tax passes the "internal consistency" test[162]---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 percent, but only 100 percent, 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

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[159] See 1 Hellerstein & Hellerstein, supra note 106, ¶ 8.08[2][b].

[160] 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).

[161] See supra note 96 and accompanying text.

[162] See supra notes 97-98 and accompanying text.

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.[163] 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 instead 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.

Finally, the single-factor sales formula does not "penalize increases in . . . activities in other States"[164] as did the tax incentive the Court condemned in Westinghouse. Indeed, it does just the opposite. While increases in property and payroll in other states have no impact on the percentage of the taxpayer's income attributed to the state, increases in sales to other states will reduce that percentage. The only "penalty" associated with the single-factor sales formula is that attributable to the different configuration of other states' apportionment formulas.

In short, Moorman demonstrates that states remain free to

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[163] See supra note 148.

[164] Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 401 (1984).

"structur[e] their tax systems to encourage the growth and development of intrastate commerce and industry"[165] insofar as state income tax apportionment formulas are concerned. The adoption of an internally consistent apportionment formula that lowers the relative income tax cost of doing business in the state by effectively assigning income to other states, and which does not penalize out-of-state activity except by reference to "internally inconsistent" assumptions made about other states' tax regimes, is precisely the type of state tax incentive to which the Court has given its implicit approval.[166] In such circumstances, the state is doing nothing functionally different from what it does when it establishes an attractive tax climate in which to operate, e.g., one with low rates, or with a narrow base, or with generous deductions for expenses wherever incurred. While such formulas may not comport with sound notions of where income is earned,[167] may give rise to duplicative taxation, and

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

[166] See Trinova Corp. v. Michigan Department of Treasury, 498 U.S. 358, 385-86 (1991).

[167] As the Court declared in General Motors Corp. v. District of Columbia, 380 U.S. 553, 561 (1965), "[t]he standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates" whereas "the geographical distribution of a corporation's sales is, by itself, of dubious significance in indicating the locus of either factor."

may maximize the revenues of particular states,[168] they do not exact a price under the state's own taxing regime for failing to engage in in-state activity.

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 decision-making 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."[169] 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[170]) will survive scrutiny under these criteria. They do not favor in-

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[168] Thus a single-factor sales formula will tend to maximize the revenues of a "market" state like Iowa which has relatively more sales than property and payroll. Conversely, a single-factor property formula will tend to maximize the revenues of an industrial state like Ohio which has relatively more property than it has payroll and sales.

[169] Boston Stock Exchange, 429 U.S. at 331; see supra Part I(C)(1).

[170] See infra notes ___-__ and accompanying text.

state over out-of-state investment, if one assumes---as one ought to[171]---that other states have adopted taxing regimes similar to the one in question.[172] 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.[173]

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[171] See supra notes 97-98 and accompanying text.

[172] Id.

[173] A recent Pennsylvania decision supports our thesis that property tax incentives of this nature will pass muster under the Commerce Clause. In PPG Industries, Inc. v. Commonwealth, No. 2355 C.D. 1987, Pa. Commonwealth Ct., Nov. 3, 1995 (unreported), reprinted in [2 Pa.] St. Tax Rptr. (CCH) ¶ 202-636, aff'd, Pa. Commonwealth Ct., June 19, 1996 (unreported), reprinted in [2 Pa.] St. Tax Rptr. (CCH) ¶ 202-657, 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 . . . ." Pa. Stat. Ann. tit. 72, § 7602(a) (Supp. 1996). The taxpayer, only some of whose manufacturing 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, it 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 with 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

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[174]---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

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> 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.

Id. at 20,440. 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.

Property tax incentives of the types described in the text would also pass muster under the view that tax incentives tied to in-state activity are acceptable so long as they do not penalize activity in other states. See supra Part III(B)(3).

[174] Maryland v. Louisiana, 451 U.S. 725, 756-57 (1981); Northwest Aerospace Training Corp. v. Commissioner of Revenue, No. 6523, Minn. Tax Ct., April 4, 1995, reprinted in [2 Minn.] St. Tax Rptr. (CCH) ¶ 202-603.

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.[175]

[175] The Court's recent 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 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

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 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 (e.g., for new manufacturing facilities) or in

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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 PPG Industries, discussed supra note 173. 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 locations (e.g., in 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 (e.g., creating a certain number of jobs in the state or making in-state investments of a certain magnitude).[176]

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[176] I recognize that the line I am drawing---between conditions that relate to the use or location of property and other conditions "independent" of the use or location of the property---may seem fuzzy at the edges. For example, one could say that conditioning a property tax exemption on the creation of ten new jobs in the state---a condition we would find constitutionally objectionable---is a condition of "use," namely,

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.[177] There is no reason 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

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"use in a business that creates ten new jobs." How, one may ask, is such a condition different from a requirement that the property be "used in a new manufacturing facility"---a condition I would find constitutionally acceptable? Without implying that I have a ready response to all such questions, I would submit that the answer lies in the distinction suggested in the text: The requirement that property be used in a new manufacturing facility is intimately connected with the acquisition and disposition of the property itself and involves no collateral conditions that could be fulfilled independently of the physical use of the property. The requirement that property be used in a business that creates ten new jobs imposes "downstream" conditions that could be fulfilled without regard to the physical use of the property. <u>See</u> <u>infra</u> notes ___-___ and accompanying text.

[177] <u>See</u> 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, <u>Untangling the Market-Participant Exception to the Dormant Commerce Clauses</u>, 88 Mich. L. Rev. 395, 463-73 (1989) (observing that market-participant exception to dormant Commerce Clause is confined to cases in which state does not impose "downstream restraints" on in-state preferences); Walter Hellerstein, Hughes v. Oklahoma: <u>The Court, the Commerce Clause, and State Control of Natural Resources</u>, 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).

fine ones, in the process of interpreting the Constitution."[178]

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.[179] 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

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[178] Walz v. Tax Comm'n, 397 U.S. 664, 679 (1970); accord, e.g., United States v. Lopez, 115 S. Ct. 1624 (1995).

[179] See [2 All States] State Tax Guide (CCH) ¶ 20-200 et seq. (1995). In Sprint Communications Co. v. Kelly, 642 A.2d 106 (D.C. Ct. App.), cert. denied, 115 S. Ct. 294 (1994), however, the District of Columbia violated the anti-coercion principle when it granted a property tax exemption for personal property used by a telecommunications company to produce receipts subject to the District's gross receipts tax, as well as a sales tax exemption for property purchased by a telecommunications company for use in producing services subject to the gross receipts tax. Consequently, only companies with District property and sales (a necessary condition to having District property and sales tax liability) could benefit from the exemptions, and then could do so only when they channeled their services into the intra-District market. As the court observed,

> the District of Columbia may not enact a tax scheme whereby the only company that can fully benefit from the available exemptions is one that sells in the District of Columbia only what it produces there, and does not afford the same benefits to a company outside the District that sells within it or indeed to a District company that sells outside it.

Id. at 116-17. Cf. Opinion of the Oregon Att'y Gen., No. 8236, April 20, 1995 (declaring enterprise zone property tax exemption unconstitutional under Privileges and Immunities Clause because it was conditioned on hiring a certain percentage of enterprise zone residents).

transaction tax incentives should track the analysis of property tax incentives offered above.[180] 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.[181] 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 do not 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)[182] are unobjectionable under these criteria. They do not favor in-state over out-of-state activity, unless one indulges

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[180] By "similar transaction tax" I mean a tax that is imposed on, or with respect to, a transaction or event associated with the transfer of personal property or services for a consideration, or the use of such property or services, and that is measured by the sales price or cost price of the property or services. Specifically, I mean to include compensating use taxes; specialized excise taxes on the sale or use of fuel, alcohol, and tobacco; and other taxes, regardless of their label, that in substance constitute retail sales taxes (such as Illinois's retailers occupation tax and Arizona's transaction privilege tax).

[181] See _supra_ Part III(A).

[182] _See generally_ [1] Multistate Sales Tax Guide (CCH) ¶ 975 (1994).

the assumption---unwarranted under general principles of Commerce Clause analysis---that other states will tax the same transaction if it were effectuated in other states.[183] 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. For this reason, such a sales tax incentive would also pass muster under the view that tax incentives tied to in-state activity are acceptable so long as they do not penalize activity in other states.[184]

There is, however, one aspect of the typical sales tax incentive that arguably distinguishes it from the typical property tax incentive and renders the former susceptible to attack under the Commerce Clause. Although both sales tax incentives and property tax incentives are confined to property used within the state, the possibility that a sales or property tax could apply to property used outside the state exists only in the context of a sales tax. There is plainly no possibility that a property tax could apply to real property used outside the taxing state, since real property can be used (and hence taxed) only in a single state. Nor can a property tax ordinarily apply to tangible personal property used outside the taxing state,

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[183] See supra notes 96-98 and accompanying text.

[184] See supra Part III(B)(3).

because constitutional strictures prohibit a state from taxing tangible personal property located in other states.[185] By contrast, states clearly have the constitutional power to impose sales taxes on property purchased in one state for use in another.[186]

Because state sales tax incentives apply only to the sale of property purchased for use within the state, it may be argued that such incentives discriminate on their face against interstate commerce and also violate the Commerce Clause's internal consistency test.[187] If every state were to exempt property purchased for in-state---but not for out-of-state---use, then property purchased in State A for use in State B (or purchased in State B for use in State A) would be subject to tax even though property purchased in State A for use in State A (or purchased in State B or use in State B) would not be. This would amount to a paradigmatic violation of the internal consistency principle and would plainly discriminate in effect against interstate commerce.[188]

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[185] Frick v. Pennsylvania, 268 U.S. 473, 488-90 (1925); Union Refrigerator Transit Co. v. Kentucky, 199 U.S. 194, 204-05 (1905). There is a limited exception to the statement in the text: Tangible personal property used in State A for part of the year and then transported to State B could be taxed in State A for the portion of the year it was located there.

[186] Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 115 S. Ct. 1331, 1339 (1995).

[187] See supra notes 97-98 and accompanying text.

[188] American Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266 (1987).

This potentially serious problem is not a problem at all, however, in light of the actual structure of sales tax regimes. Sales taxes are levies confined to the final sale of a product for "use or consumption"[189] within the taxing state. In keeping with this design (as well as the desire not to put local vendors at a disadvantage to their out-of-state competitors), "[m]ost states exempt from tax all sales for delivery outside the state."[190] Because states generally do not tax the sale of property for out-of-state use, there is therefore little risk of discrimination against interstate commerce, or violation of the internal consistency doctrine, when a state provides a tax break for the sale of certain property for in-state use.[191] In other words, because the state taxes sales of goods only for intrastate use, there cannot possibly be a discrimination against interstate commerce when sales for some, but not other, intrastate uses are made tax-exempt.

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

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[189] John F. Due & John L. Mikesell, Sales Taxation: State and Local Structure and Administration 16 (2d 1995).

[190] Id. at 271; see also 2 Hellerstein & Hellerstein, supra note 106, at ¶ 18.02[1].

[191] If there is discrimination in such a sales tax scheme, it is against in-state sales that do not qualify for the exemption. But that is not a concern of the Commerce Clause. See supra note 110.

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.[192]

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;[193] 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;[194] or Illinois's 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

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[192] For example, assuming arguendo that the exemption at issue in Bacchus were not invalid on the ground that it represented an exemption from existing tax liability, see supra notes 105-06 and accompanying text, it might still be struck down on the ground that it imposed "downstream" conditions on new investment in the state. One could argue that the condition of the exemption in Bacchus---that the exemption applies only if one sells property produced in the state---goes beyond the scope of acceptable conditions bearing strictly on the in-state use of the of the property sold. Linking an exemption to the in-state use of the property, which is intimately connected with the design structure of a sales tax directed at in-state consumption, is a far cry from linking it to the in-state production of the property, which bears no structural relationship to the tax being imposed and arguably imposes a condition "independent" of those activities that give rise to the liability in the first place.

[193] Ariz. Rev. Stat. Ann. § 42-1322.01 (Supp. 1995).

[194] Ark. Code Ann. §§ 26-52-901 et seq. (Michie 1992, Supp. 1993).

that create a minimum of 200 jobs in the state;[195] 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;[196] 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;[197] or Oklahoma's exemption from sales and use taxes for purchases of tangible personal 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;[198] 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.[199]

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---

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[195] Ill. Comp. Stat. Ann. ch. 35, ¶ 120/1f (West 1993).

[196] Neb. Rev. Stat. § 77-27,188 (1990, Supp. 1994).

[197] N.M. Stat. Ann. § 7-9A-7.1 (Michie 1995).

[198] Okla. Stat. tit. 68, §1359(8) (Supp. 1996).

[199] S.D. Codified Laws Ann. § 10-45B-1 et seq. (Supp. 1995).

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[200]---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.[201] Such

[200] See supra Parts IV(A)(1) and IV(A)(2).

[201] A recent Minnesota case is illustrative. In Northwest Aerospace Training Corp. v. Commissioner of Revenue, No. 6523, Minn. Tax Ct., April 4, 1995, reprinted in [2 Minn.] St. Tax Rptr. (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. . . .

incentives 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

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> 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 escape 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 <u>and</u> a sales tax.

<u>Id</u>. at 14,630 (emphasis in original).

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 engage in in-state activity that it might undertake even if it had never purchased the property (e.g., creating a certain number of jobs in the state or making in-state investments of a certain magnitude).[202]

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[202] I recognize, as I did in the context of property tax incentives (see supra note 175) that the line I am drawing---between conditions that relate to the use or location of property

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. 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, the "race to the bottom" may well be ended in mid-course.

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and other conditions independent of the use or location of the property---may appear blurry in some contexts. Why, one may ask, is use of a property in a new facility any more a condition of use than use of property in a facility that creates ten new jobs? My response mirrors the response I offered to the analogous question I raised in the context of property tax incentives: if the condition can in substance be fulfilled without regard to the physical acquisition or disposition of the property, it ought to be regarded as "independent" of use or location. In our judgment, the requirement of use in a new facility clearly falls on one side of the line and the requirement of use in a new facility that creates ten new jobs falls on the other.