Testimony of Walter Hellerstein

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of the

Committee on Finance
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Hearing on

"*Cuno* and Competitiveness: Where to Draw the Line"

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I am Walter Hellerstein, the Francis Shackelford Professor of Taxation at the University of Georgia School of Law. I have devoted most of my professional life to the study and practice of state taxation and, in particular, to state taxation of interstate commerce and the federal constitutional restraints on such taxation.

I am honored by the Chairman's invitation to testify today. I welcome the opportunity to share with the Subcommittee my views on whether Congress should draw a line between appropriate economic development incentives and inappropriate state tax discrimination and, if so, how Congress should draw that line. I do not appear here on behalf of any client, public or private, and the views I am expressing here today reflect my independent professional judgment.[1]

My testimony can be succinctly summarized in two sentences. First, I believe Congress should draw a line between appropriate economic development incentives and inappropriate state tax discrimination. Second, I believe Congress should act with extraordinary care in drawing that line.

I. WHY CONGRESS SHOULD DRAW A LINE BETWEEN APPROPRIATE ECONOMIC DEVELOPMENT INCENTIVES AND INAPPROPRIATE STATE TAX DISCRIMINATION

It is not an overstatement to characterize the U.S. Supreme Court's dormant Commerce Clause doctrine imposing restraints on state taxation of interstate commerce as a "quagmire." Indeed, almost half a century ago the U.S. Supreme Court itself described the doctrine that way,[2] and things have not gotten much better.[3] Moreover, in no context is the confusion and uncertainty created by the Court's Commerce Clause doctrine more profound than in the domain of state tax incentives for economic development. As I testified earlier this year before a House Subcommittee looking into the *Cuno* problem,[4] perhaps the one point on which virtually all observers would agree is

[1] In the interest of full disclosure, it should be noted that I am of counsel to Sutherland Asbill & Brennan LLP; Sutherland is counsel to the Council On State Taxation (COST), which is actively supporting a congressional resolution of the state tax incentive issue raised by *Cuno v. DaimlerChrysler*. As I have just stated, however, the following testimony represents my independent professional judgment, and it does not necessarily represent the views of any institution or organization with which I am affiliated.

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

[3] See generally 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ch. 4 (3rd ed. 1998 & Cum. Supp. 2005) (taking more than 300 printed pages to describe U.S. Supreme Court's dormant Commerce Clause doctrine).

[4] Walter Hellerstein, *Economic Development and the Dormant Commerce Clause: Lessons of* Cuno v. DaimlerChrysler *and its Effect on State Taxation Affecting Interstate Commerce*, *Before the Subcomm. on the Constitution and the Subcomm. on Commercial and Administrative Law of the House Comm. on the Judiciary*, 109th Cong., 1st Sess. (May 24, 2005).

that “the law in this area is indeterminate,” and that, “[l]less charitably put, it is a mess, albeit a mess that keeps many lawyers and law professors busy.”[5]

The *Cuno* case, of course, is a poster child for this “mess.” How can anyone explain, as the *Cuno* case held, how (a) an income tax credit to attract business to a state violates the Commerce Clause while (b) a property tax abatement to attract that same business to the state does not?[6] But *Cuno* is just the tip of the iceberg. There are literally hundreds of state tax incentives enacted for economic development purposes that arguably fall on one side or the other of the line the Court has drawn between permissible and impermissible inducements. Whether they fall on the right side or the wrong side of the line depends on an inquiry into such questions as whether the measure is:

- a permissible direct subsidy of domestic industry that “‘does not ordinarily run afoul’ of the negative Commerce Clause”[7]; or
- an incentive falling within the Court’s recognition 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]; or
- an incentive designed to achieve that same objective – “to encourage the growth and development of intrastate commerce and industry” – but that “forecloses tax-neutral decisions”[9]; or
- an incentive that “‘provid[es] a direct commercial advantage to local business.’”[10]

Because the answers to these questions are often unclear, in many cases it is anyone’s guess whether a particular economic development measure falls on the right or wrong side of that line.

[5] *Id.* at 10.

[6] Although I must plead guilty to having tried to explain that very distinction, Walter Hellerstein & Dan T. Coenen, “Commerce Clause Restraints on State Business Development Incentives,” 81 *Cornell Law Review* 789 (1996)), and acknowledge that the Court of Appeals for the Sixth Circuit relied on that explanation in striking down Ohio’s investment tax credit while sustaining the property tax abatement, *Cuno v. DaimlerChrysler, Inc.* 386 F.3d 738 (6th Cir. 2004) (citing *id.* at 806-09), I would be the first to admit (and have in fact admitted) the extraordinary difficulties in attempting to delineate “the ill-defined distinction between the constitutional carrot and the unconstitutional stick in state tax, subsidy, and related cases.” Hellerstein & Coenen, *supra*, at 792.

[7] *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 199 n.15 (1994) (quoting *New Energy Co. v. Limbach*, 486 U.S. 269, 278 (1988)).

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

[9] *Id.* at 331. One may reasonably ask whether a tax incentive that does *not* “foreclose tax-neutral decisions” is even worthy of its name, since that is precisely what a tax incentive is designed to do.

[10] *Id*. at 329 (quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959)).

Right now, for example, in Wisconsin, the state supreme court is struggling with the question of whether the state's property tax exemption for airlines that operate "hub facilities" in the state violates the dormant Commerce Clause,[11] a question that the Wisconsin Court of Appeals certified to the state supreme court because it "presents issues of statewide and national importance involving the ability of the state to provide tax incentives for businesses to locate, upgrade, or remain in the state."[12] While perhaps not of the same pressing importance, except to my state and local tax students to whom I gave the problem as an examination question last semester, is the question of the constitutionality of Georgia's headquarters credit for new investment in the state.[13] I could have chosen a similar example from virtually any other state.

The problem created by this uncertainty for taxpayers and taxing authorities alike is self-evident. Taxpayers who have reasonably relied on these economic development incentives in the past have no assurance that these provisions will survive Commerce Clause challenge and thereby deprive them of benefits on which they may have made locational and budgetary decisions. Moreover, this uncertainty has a highly unsettling impact on future decision-making regarding industrial location. State taxing authorities whose incentive provisions may be vulnerable to attack likewise face difficult administrative decisions in determining how to redress the discrimination, especially in

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[11] *Northwest Airlines, Inc v. Wisconsin Dep't of Revenue*, 281 Wis. 2d 117, 697 N.W.2d 475 (2005).

[12] *Northwest Airlines, Inc v. Wisconsin Dep't of Revenue*, No. 04-0319, 2005 WL 487882 (Wis. App. 2005).

[13] Here was the question:

> Georgia Code § 48-7-40.17 provides, in pertinent part:
>
> (a) As used in this Code section, the term: …
>
> > (3) "Headquarters" means the principal central administrative office of a taxpayer or a subsidiary of the taxpayer.
>
> (b) A taxpayer establishing its headquarters in this state or relocating its headquarters into this state which:
>
> > (1) Within one year of the first date on which it withholds wages for employees at such headquarters …employs at least 100 persons in new full-time jobs at such headquarters…; or
> >
> > (2) Within one year of the first date on which it withholds wages for employees at such headquarters … incurs within the state a minimum of $1 million in construction, renovation, leasing, or other costs related to such establishment or relocation …shall be allowed a credit for taxes imposed under this article equal to $2,500.00 annually per eligible new full-time job.

Your client has recently relocated its headquarters to Georgia. It has added 75 persons in "new full-time jobs at such headquarters" within the meaning of the foregoing statute, and it has incurred $500,000 of "construction, renovation, leasing, or other costs related to such establishment" within the meaning of the statute. The Georgia Department of Revenue has denied your client the credit described above, and your client has asked your advice as to whether a Commerce Clause challenge to such denial will be successful. Write a memorandum providing the requested advice.

light of the constitutional requirement that those who have been the victim of unconstitutional state tax discrimination are entitled to "meaningful backward-looking relief."[14] The state budgetary implications of this requirement can also be daunting. Accordingly, wholly apart from any question of whether state tax incentives are wise as a matter of policy – an issue on which others are better positioned to testify and to which my testimony is not directed – the existing indeterminacy of the law governing the constitutionality of these incentives under the Commerce Clause calls for a solution.

That solution will not come from the U.S. Supreme Court or from other courts that are bound to follow its guidance. As Justice Frankfurter observed nearly 50 years ago:

> At best, this Court can only act negatively; it can determine whether a specific state tax is imposed in violation of the Commerce Clause. Such decisions must necessarily depend on the application of rough and ready legal concepts. We cannot make a detailed inquiry into the incidence of diverse economic burdens in order to determine the extent to which such burdens conflict with the necessities of national economic life. Neither can we devise appropriate standards for dividing up national revenue on the basis of more or less abstract principles of constitutional law, which cannot be responsive to the subtleties of the interrelated economies of Nation and State.
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> The problem calls for solution by devising a congressional policy. Congress alone can provide for a full and thorough canvassing of the multitudinous and intricate factors which compose the problem of the taxing freedom of the States and the needed limits on such state taxing power.[15]

In short, the problem raised by *Cuno* is broader than *Cuno* itself. Failure by Congress to act on the underlying issue raised by *Cuno* will effectively leave us in the "mess" we are in. Wholly apart from the wisdom or effectiveness of state tax incentives or the defensibility of various competing readings of the dormant Commerce Clause that may be advanced, failure by Congress to act will assure continuing uncertainty and, most probably, inconsistency in judicial determinations of the validity of state tax incentives. To reiterate what I said to a House subcommittee earlier this year: "However Congress may resolve the ultimate question of what types of tax incentives represent appropriate measures to encourage economic development, we are all better off if Congress draws a clear line that is discernible to all than if we are left to the vagaries of the judicial process that has created the uncertainty and controversy that we face today."[16]

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[14] *McKesson v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18, 31 (1990).

[15] *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 476 (1959) (Frankfurter, J., dissenting). The Court expressed similar sentiments in *Commonwealth Edison Co. v. Montana*, 453 U.S. 609 (1981) and in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978).

[16] Hellerstein, *supra* note 4, at 13.

II. HOW CONGRESS SHOULD DRAW THE LINE BETWEEN ACCEPTABLE ECONOMIC DEVELOPMENT INCENTIVES AND UNACCEPTABLE STATE TAX DISCRIMINATION

If Congress decides to legislate in this area and to draw a line between acceptable economic development incentives and unacceptable state tax discrimination, my principal recommendation is simple: *be careful*. I say that for the following reason: one person's "economic development incentive" is often another person's "discriminatory tax." New York's "economic development incentive" to attract sales to the New York exchanges was a "discriminatory tax" to the Boston Stock Exchange that viewed the incentive as diverting economic activity from the Boston exchange, a view with which the U.S. Supreme Court concurred.[17] Hawaii's "economic development incentive" for its fledging wine industry was a "discriminatory tax" to sellers of alcoholic beverages produced in other states, a view with which the U.S. Supreme Court concurred.[18] New York's "economic development incentive" for business involved in export shipment from New York was a "discriminatory tax" for those making export shipments from other states, a view with which the U.S. Supreme Court concurred.[19] And Ohio's "economic development incentive" for gasohol produced in the state was a "discriminatory tax" to those who produced gasohol in other states, a view with which the U.S. Supreme Court concurred.[20] Consequently, in drawing the line between acceptable and unacceptable economic development incentives, Congress must act with great care to assure that it is neither approving as "economic development incentives" provisions that, on further reflection, constitute unwarranted "state tax discrimination," or, alternatively, that it is not condemning as "state tax discrimination," provisions that, on further reflection, constitute permissible "economic development incentives."

Let me provide you with one recent example of the delicate task that Congress faces. Two weeks ago today the Missouri House of Representatives passed by a resounding 152-1 margin an exemption from Missouri sales taxes for "all sales of new motor vehicles assembled and sold in the State of Missouri after January 1, 2007."[21] The bill was obviously enacted with the wholly laudable and understandable purpose of encouraging economic development in Missouri by eliminating the tax on motor vehicles assembled in the state. But it does not take a Nobel-prize winning economist to appreciate the implications of this legislation for the sale in Missouri of automobiles manufactured in Illinois, Ohio, or Michigan. The question Congress faces, then, is how to draw the appropriate line between *Cuno*-type incentives, which many believe are

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

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

[19] *Westinghouse Electric. Corp. v. Tully*, 466 U.S. 388 (1984).

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

[21] House Bill No. 1249, 93rd General Assembly, State of Missouri, March 2, 2006,

appropriate, and the Missouri incentive, which, I will venture to presume, many would find inappropriate.

Without speaking to the merits of the particular line that Congress may wish to draw, I nevertheless believe that the legislation introduced into Congress by Senator Voinovich and Representative Tiberi[22] makes an excellent start at the process of drawing such a line. It represents a considered effort to strike a balance between the ability of the states, in their sovereign capacities, to adopt programs designed to attract economic activity to the state and the needs of the nation to maintain the national common market that has been essential to our country's economic prosperity.

Attached to this testimony is my analysis of this proposed legislation from a technical standpoint. Specifically, it describes how it would modify the constitutional landscape reflected in *Cuno*. Insofar as I suggest changes in the proposed statute, it is my intention to improve upon legislation that I support in principle and, with the changes suggested, would support in practice as a technically sound implementation of what I perceive to be the proposed legislation's apparent intent.

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Once again, I thank the Chairman for inviting me to testify before this Subcommittee, and I will be happy to respond to any questions or to provide any other assistance that the Chairman or other Members of the Subcommittee may find helpful.

[22] See S. 1066, 109th Cong., 1st Sess. (2005); H.R. 2471, 109th Cong., 1st Sess. (2005).