**Statement of the**

## Federation of Tax Administrators

**Before the**

## Subcommittee on International Trade
## Committee on Finance
## U.S. Senate

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

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Mr. Chairman and Members of the Committee:

My name is Harley Duncan. I am Executive Director of the Federation of Tax Administrators. The Federation is an association of the principal state tax administration agencies in the 50 states, D.C., and New York City. Thank you for the opportunity to appear before you today to discuss the *Cuno* decision and S. 1066, the Economic Development Act of 2005.

The policy of our organization regarding this matter is contained in a resolution adopted by our members at the June 2005 Annual Meeting in San Antonio. That policy supports S. 1066 and offers the auspices of our organization to work with the states and Congress to arrive at federal legislation that would protect state and local governments' interest in offering tax incentives. The sponsors of the bill worked with FTA and its members to improve the clarity and precision of the bill and to address concerns about the effects the bill might have on existing state and local tax incentives. We believe that the bill represents a good-faith effort to balance the states' interests in offering incentives and avoiding harmful discrimination against interstate commerce. My statement will focus on three points: the need for Congress to act in this area; the need to avoid discrimination against interstate commerce; and the importance of certain language in the bill.

**The need for S. 1066.** As you know, in its 2004 decision in *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738 (2004), the U.S. Court of Appeals for the Sixth Circuit determined that an investment tax credit offered by the City of Toledo, Ohio and other Ohio jurisdictions violated the Commerce Clause of the federal constitution. The city and other political subdivisions had entered into a development agreement with an automobile

manufacturer, by which the manufacturer would receive $280 million in local property and state corporate franchise tax benefits, to induce the manufacturer to stay in the city. The federal district court had upheld the constitutionality of the incentives, on the basis that, while an increase in Ohio activity could increase the tax benefits for the manufacturer, the benefits were not decreased as a result of an increase in activity outside of Ohio. The appellate court, however, rejected the position that tax incentives were permissible as long as they did not penalize out-of-state economic activity. The appellate court instead determined that U.S. Supreme Court decisions had not distinguished between laws that benefit in-state activity and laws that burden out-of-state activity, and that, "economically speaking, the effect of a tax benefit or burden is the same." The court ruled that the investment tax credit discriminated against interstate commerce in violation of the Commerce Clause (while the constitutionality of a property-tax credit was upheld). The U.S. Supreme Court agreed to review that decision, and oral argument of the case was heard by the Court on March 1, 2006.

While we at FTA have not attempted to catalog all of the tax incentives offered by state and local governments, we can say with some confidence that there are many such incentives that would be difficult to distinguish in any material way from the incentives involved in *Cuno*. Consequently, if that decision is allowed to stand, those incentives would be vulnerable to attacks based on the *Cuno* decision. There are already actions challenging tax incentives pending in North Carolina and Minnesota, and there is every reason to believe that, if Sixth Circuit position holds, there will be more such actions filed. Such challenges would call into question the constitutional validity of the multitude of existing arrangements that many businesses have relied upon in making decisions regarding the locations of their plants and other properties. The negative impact on corporate balance sheets and shareholder value would be extremely detrimental. In addition, the challenges would disrupt or negate a substantial component of each state's development program.

Beyond the issue of the constitutionality of tax incentives, some commentators and litigants have questioned the effectiveness and wisdom of offering such incentives. We

do not believe that is the question before this Committee. It is clear that each state believes tax incentives are an important part of its economic development effort as witnessed by the number of programs in place. We believe the issue of whether and what types of incentives are effective and in what circumstances they should be offered are issues that are best resolved by state and local elected officials operating in their normal legislative and administrative processes. The ability to structure one's tax system is one of the most basic and integral aspects of state sovereignty and should be subject to the control of state and local elected officials. Therefore, if the *Cuno* decision is not overturned, we believe it is important that Congress act to preserve the ability of states and localities to offer tax incentives for economic development purposes.

**Avoiding impermissible discrimination against interstate commerce.** It is clear that the Commerce Clause gives Congress the authority to act in matters involving interstate commerce. In fact, the Supreme Court has encouraged Congress to do so, for example, in the matter of determining what would constitute sufficient nexus with a state to allow that state to require an out-of-state seller to collect the state's use tax. In *Quill Corp. v. North Dakota*, 112 S.Ct. 1904, 1916 (1992), after rejecting the state's position that the time had come to renounce a test for nexus that had been established in an earlier decision, the Court stated, "This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve." (Footnote omitted.)

Similarly, if the U.S. Supreme Court does not overturn the *Cuno* decision on the merits (as opposed to deciding the case on the standing issue, which appears to be a distinct possibility), Congress should address the issue of the constitutionality of state tax incentive. In doing so, however we believe it will be necessary not only to authorize the use of certain types of tax incentives, but to also provide guidance as to what types of incentives would not be acceptable in that they would constitute impermissible discrimination against interstate commerce. In our view, the goal of federal legislation in this area should be to reestablish the lay of the land as it was commonly understood prior to *Cuno*. We believe S. 1066 effectively accomplishes this task.

As you know, the U.S. Supreme Court has ruled that a variety of state tax preferences have violated the Commerce Clause by impermissibly discriminating against interstate commerce. Those decisions involved preferences in the form of, for example, a West Virginia gross receipts tax that exempted in-state manufacturers, *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984); a New York gross receipts tax that allowed a credit for sales of products shipped from New York but not from other locations, *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984); an excise tax exemption only for alcoholic beverages produced in Hawaii, *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984); and, a New York tax scheme that imposed a higher tax on transfers of stock occurring outside the state than was imposed on transfers involving a sale within New York, *Boston Stock Exchange v. State Tax Commissioner*, 429 U.S. 318 (1977). These and other cases provide guidance as to what types of incentives are acceptable and unacceptable, and are the decisions that, to a large extent, have been encapsulated in the list of types of incentives that are not authorized by S. 1066, in Section 3(a) of the bill. Therefore, while S. 1066 provides a general authorization for state tax incentives in Section 2, it balances that authorization with a statement of what types of incentives are not authorized.

In reaching its decision in *Boston Stock Exchange*, the Court described the state of the law as follows:

> Our decision today does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry. Nor do we hold that a State may not compete with other States for a share of interstate commerce; such competition lies at the heart of a free trade society. We hold only that in the process of competition no State may discriminatorily tax the products manufactured or the business operations performed in any other state.

429 U.S. 336, 337. S. 1066 strikes the balance contemplated by the Supreme Court, between the encouragement of intrastate business and the prohibition against discrimination against interstate commerce.

The importance of certain language in the bill. As described, S .1066 is an attempt to balance a general authorization of tax incentives for economic development with restrictions that would prevent impermissible discrimination by removing from that authorization incentives that fit within the drafters' characterizations of several U.S. Supreme Court decisions striking down incentives. That is not a process that can produce precision for at least two reasons: (a0 U.S. Supreme Court rulings are often not suited to brief encapsulations; and (b) one cannot know with certitude which state tax incentives would fall within the ambit of each of those provisions. That would leave open the question of what would happen to a tax incentive that, by falling within the ambit of a provision describing an incentive that is not authorized by the bill. That is, would such an incentive be considered in violation of the Commerce Clause, because Congress had addressed, or occupied, the area of state tax incentives and had explicitly not authorized that incentive? As you can imagine, this is a critical question. That question is addressed by Section 3(b) of the bill.

While Section 3(a) sets out the "Tax Incentives Not Subject to Protection Under This Act," Section 3(b) states:

> No Inference. – Nothing in this section shall be construed to create any inference with respect to the validity or invalidity under the Commerce Clause of the United States Constitution of any tax incentive described in this section.

As we read this section – and have been assured by the drafters of its meaning – Section 3(b) provides that, if a tax incentive falls within the ambit of Section 3(a), so that it is not authorized by Section 2 of the bill, it cannot be inferred by the courts that that incentive is invalid under the Commerce Clause. That is, such an incentive is merely not authorized by the bill, but is not in any way prohibited or invalidated by the bill. Therefore, if a court were to determine that an incentive fell within the ambit of Section 3(a), so that it was not protected by the bill, the court would then undertake its own analysis of whether

the bill was valid under the Commerce Clause, with this bill being silent as to that question.

Section 3(b) is critical to the states. As noted above, given the lack of precision inherent in any attempt to encapsulate a U.S. Supreme Court decision in a handful of words, there is no way for state and local governments to know just which of their tax incentives might fall within the ambit of Section 3(a). Therefore, state and local governments need to know that, if one of their incentives does fall within the ambit of Section 3(a), so that it is not specifically authorized by this bill, that incentive will not be deemed invalid, but rather, will be analyzed for constitutionality by the courts in accordance with current Commerce Clause standards. The inclusion of Section 3(b) in the bill is critical to the ability of the bill to restore the use of tax incentives as they existed prior to *Cuno.*

**Conclusion.** If the Supreme Court does not overturn *Cuno* on the merits, state and local governments will need guidance on how they can implement policies of attracting businesses to their jurisdictions without discriminating against interstate commerce in violation of the Commerce Clause, and, as indicated above, Congress is uniquely situated, and empowered by the federal constitution, to do that. We believe that S. 1066 represents an appropriate balance between authorizing state tax incentives for economic development and preventing impermissible discrimination. It should be effective in meeting our goal of restoring the state of affairs prior to *Cuno.*