Learning Objectives:

At the end of this session the learner should be able to:

- Identify taxing powers possessed by subnational (i.e., state and local) governments
- Recognize state law limitations on local governments
- Identify state law limitations on taxpayers
- Recognize select U.S. Constitutional limitations
Prologue

• The legality of incentives cannot be answered in a vacuum; answers require a contextual analysis informed by application of the relevant law to each situation's facts and circumstances
• Incentives implicate a wide range of factors that include, among other things, different jurisdictions, levies, funding sources, targeted activities, and underlying rationales for offering the incentives in the first place
  ◦ Depending on their context, these variables can impact the analysis of whether a sought after benefit is at risk of legal challenge

Prologue (Cont’d)

• For instance, non-tax incentives may be subject to challenge if impermissibly funded with tax revenues; thus, one cannot ignore the reciprocal aspects of the powers to tax and not tax
• The temptation to ignore risks as more “theoretical” than “real”, have humbled many a taxpayer over the years
• Frequently difficult legal questions exist, e.g.,
  ◦ Which subnational and national tax and non-tax laws apply to the sought after incentive?
  ◦ Who and why would a person want to challenge the desired incentive?
  ◦ To limit potential challenges, what safeguards and actions should the person seeking the benefit take currently?
Prologue (Cont’d)

• Following is how we will address this topic, along with our thoughts regarding related risks and suggested safeguards one should consider to reduce those risks.

Agenda

• Subnational government taxing powers
• State law limitations on local governments
  ◦ Public purpose
  ◦ Permitted levies (taxes v. fees)
  ◦ Other
• State law limitations on taxpayers
  ◦ Business purpose
  ◦ Subsequent law changes
  ◦ Clawback provisions
• Select Constitutional limitations
  ◦ Seminal cases: CC anti-discrimination prong
State and Local Source of Power to Tax

Power to Tax

- Where not limited by U.S. Constitution, State governments do not need Federal powers to act.
  - The general power possessed by the States and not by the federal government is frequently referred to as the “police powers” of the State.
Power to Tax (cont’d)

- A locality’s power to tax is ultimately derived from the state
  - States are sovereign entities that ceded powers to the federal government
  - States may also cede powers (e.g., to tax) to its political subdivisions
    - Accordingly, a State’s constitution is the starting point to ascertain powers of local government to tax

Power to Tax (cont’d)

- Local taxing authorities in the US go by various names (e.g., cities, municipalities, villages, counties, townships, authorities), and exist under the powers of the state.
- While state law is supreme over local government, the laws of the state may set boundaries as to how the state may intrude on the powers of the local authorities
Power to Tax (cont’d)

◦ Some states have the power to totally abolish any or all local governments
◦ Other states, e.g., MI, are restricted by the state’s constitution to the degree and process by which they may interfere

Power to Tax (cont’d)

• Given that police powers can be broader than scope of Congress’ CC authority, without other federal limitations with “teeth” taxpayers can become “victims.”
Illustrative Local Limitations

- Public Purpose
- Permitted Levies
  - Taxes v. Fees
- Other

Public Purpose

- Many state constitutions provide or imply that local taxes may only be levied to serve a public purpose
- Determinative factors include
  - Usage of revenues by the government
  - Custom and history of taxing the object
  - Necessary to the support and proper use of government
  - Sanctioned by time and acquiescence of the people
Public Purpose (cont’d)

- Permissible public purposes include taxes used to support the benefits and protections of government, e.g., schools, transportation, infrastructure, fire and police protection.

Public Purpose (cont’d)

- Purposes found not permissible (i.e., serving “private” interests) include:
  - Funding mortgages for rebuilding after a fire
  - Subsidies to private schools
  - Market participant entries, e.g., purchase and operation of an ice plant.
Permitted Levies

- Another important limitation on local taxing powers frequently relates to their authority to impose different forms of levies
- Accordingly, among other things, it is important for one to understand the difference between a “tax” and a “fee”

Taxes v. Fees

- Taxes v. Fees
  - A tax raises revenue not necessarily connected to the activity being taxed
  - A fee is generally imposed at lower rates and is connected to a direct government cost
  - State law may limit a locality's taxing powers, yet permit a fee under its police powers
  - Different federal constitutional standards may apply as well
Taxes v. Fees (Cont’d)

- Local levies may be circumscribed or permitted subject to their characterization as a tax or fee. C.f., e.g.,
  - *Dress Co. v. Hamilton Township*, Ohio, No. 2012-Ohio-2370 (May 31, 2012) (impact fees were taxes, which the township was not authorized to impose), with

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The Court in *2nd Roc-Jersey Associates* found:

- Special assessments, unlike taxes, are not subject to the uniformity principle.
- Therefore a subset of the tax roll (in this case, residential properties) may be lawfully exempted from paying the assessment.
- Special assessments may be used to fund economic development projects, not just physical infrastructure improvements.
Other Local Limitations

- In addition to public purpose, other State constitutional limitations applicable to localities may include
  - Uniformity
  - Equal protection
  - Home rule/charter authority
  - Other, e.g.,
    - Rate caps
    - Total amount of tax caps
    - Supermajorities
    - Taxpayer votes
    - Judicial restraints against legislating
    - Delegations to legislature to set parameters

Illustrative State Law Limitations on Taxpayers
Business Purpose


The Tax Appeals Tribunal held that the company was entitled to the tax incentives because the reorganization had a valid business purpose and obtaining tax benefits was not the sole purpose of the new entity’s formation.

It specifically stated “that it is more accurate to view the operational changes, as well as the loan, grant, Empire Zone tax benefits, and the creation of a new entity, as ancillary steps towards saving the business of Ward Lumber I by acquiring [a] credit extension…Under these particular circumstances, we conclude that the reorganization was a step in a plan that was motivated by various non-tax purposes, as required under the “primary motivation” prong of [the statute]”.

Impact of Subsequent Law Changes


The court held that the amended statutory formula was inapplicable to the orders issued to Philip Morris because those orders already prescribed the “best calculated” method to determine the income allocable the state for income tax purposes.
Scope of Clawback Provisions


The Board of Tax Appeals held that Shawnee County did not have authority to tax Target’s property because “Target’s failure to meet its job retention obligations would trigger clawback payments, not an event of default resulting in forfeiture of the exemption.”

Federal Limitations, e.g.,

- Establishment Clause
- Dormant Commerce Clause
Establishment Clause

In Budlong v. Graham, 414 F Supp 2d 1222 (DC Ga., 2006), tax exemption violated the Establishment Clause because:

- The unique and preferential treatment to “religious” literature raised serious constitutional concerns under the Establishment Clause, especially following the Supreme Court’s decision in Texas Monthly, Inc. v. Bullock (citations omitted).
- The exemptions were incompatible with the First Amendment’s proscription against laws “abridging the freedom of speech, or of the press[.]”
- The statutory provisions, by excepting from tax “religious [p]apers” and “Holy Bibles, testaments, and similar books[,]” impermissibly treated certain publications more favorably than others based on their content.

Dormant Commerce Clause

- When a state or local tax incentive rewards a multistate corporation’s in-state activities without similarly rewarding its out-of-state activities, it ties the taxpayer’s effective tax rate to the choice of whether or not to conduct an activity within the state.
- This raises an important question under the dormant commerce clause that has not been answered by the U.S. Supreme Court:
  - Does an unconditional state tax incentive limited to in-state activities of the taxpayer impermissibly discriminate against “protected commerce” in favor of local commerce?
Illustrative Fact Pattern: Assume

“State Alpha” and “State Beta” impose a ten percent tax on corporate income, and Alpha offers a credit equal to five percent of a taxpayer’s research and development (R&D) expenses incurred within its borders. “Taxpayer One” exclusively operates in Alpha and for the taxable period earned $200 of income while expending $100 on R&D. “Taxpayer Two” operates in Alpha and Beta where it likewise earned $200 of income and expended $100 on R&D, albeit equally divided between the two states.

Illustrative Fact Pattern: Assume (cont’d)

• Taxpayer One owes Alpha $15 of tax: $20 of tax ($200 x 10%) less the $5 ($100 x 5%) R&D credit. Its effective tax rate (ETR) is 7.5 percent ($15 ÷ $200).
• Taxpayer Two owes Alpha $7.50 of tax: $10 of tax ($200 x 50% x 10%) less the $2.50 ($50 x 5%) R&D credit. In addition, Taxpayer Two owes Beta $10 of tax ($100 x 10%). Its ETR in Alpha is 3.75 percent ($7.50 ÷ $200); in Beta, 5 percent ($10/$200); and, overall 8.75 percent ($17.50 ÷ $200)
Permissible incentive or discriminatory tax?

In *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738, 745 (6th Cir. 2004) the CA-6 ruled

- ITC found to discriminate against interstate economic activity, in violation of CC.
- PPT exemption found not to violate the CC because “the conditions for obtaining the favorable tax treatment are related to the use or location of the property itself”.
- **NOTE:** The US Sup Ct dismissed this case for lack of standing. Thus, the issues raised by the CA-6 remain to be decided by the Court.

Conclusion
Key Points:

- The legality of incentives cannot be answered in a vacuum
  - Frequently difficult legal questions exist that require analysis of areas outside the tax laws
- Where not limited by the U.S. Government, State governments do not need Federal powers to act
  - A locality’s power to tax is ultimately derived from the state

Key Points (cont’d):

- A locality’s power to tax may be circumscribed by various limitations
  - E.g., public purpose and permitted levies
- Similarly, a taxpayer’s ability to reap the benefit of a tax incentive may be circumscribed by various limitations
  - E.g., business purpose and clawback provisions
- Federal limitations on the powers of subnational governments to impose taxes and fees are the final authority when parceling between the permissible and impermissible in this complex area of the law
Appendix

Commerce Clause – Seminal Discrimination Cases

Seminal Discrimination Cases - Agenda

Seminal Discrimination Cases - Agenda (Cont’d)

- Wardair Canada, Inc. v. Dep’t of Revenue, 477 U.S. 1 (1986)

Seminal Discrimination Cases - Agenda (Cont’d)


Summary of Seminal Anti-Discrimination Cases
Seminal Cases – Discrimination Prong

_Boston Stock Exch. v. State Tax Comm'n,_ 429 U.S. 318, 335 (1977) (holding that New York transfer tax on securities transactions was unconstitutional because transactions involving an out-of-state sale were taxed more heavily than most transactions involving a sale within the state).

Seminal Cases – Discrimination Prong (Cont'd)

_Maryland v. Louisiana,_ 451 U.S. 725 (1981) (finding Louisiana First-Use Tax violated the Commerce Clause because Louisiana consumers of a certain gas were protected from the impact of the tax through credits and exclusions provided against other non-apportioned Louisiana taxes, while gas moving out of state was burdened with tax).
Seminal Cases – Discrimination Prong (Cont’d)

*Bacchus Imps., Ltd. v. Dias*, 468 U.S. 263 (1984). (Liquor tax exemption for locally produced wines invalid, because it had both the purpose and effect of discriminating in favor of local products.)

Seminal Cases – Discrimination Prong (Cont’d)

Seminal Cases – Discrimination Prong (Cont’d)

Wardair Canada, Inc. v. Dep’t of Revenue, 477 U.S. 1, 9 (1986) (pointing out, as support for its holding that a Florida aviation fuel tax did not violate the Commerce Clause, that dormant commerce clause principles did not apply in this case because the federal government had acted affirmatively in the area and therefore it was not the responsibility of the judiciary to determine whether state action threatened commerce clause values)

Seminal Cases – Discrimination Prong (Cont’d)

Seminal Cases – Discrimination Prong (Cont’d)

New Energy Co. of Indiana v. Limbach, 486 U.S. 269 (1988) (Ohio tax credit for motor vehicle fuel tax for each gallon of ethanol produced in Ohio invalid, because credit denied to out-of-state business unless their home state provided a similar tax advantage to ethanol produced in Ohio).

Seminal Cases – Discrimination Prong (Cont’d)

West Lynn Creamery, Inc. v. Healy, 512 U.S. 186 (1994) (striking down a Massachusetts milk pricing order that in effect taxed all sellers of milk in the state, but only provided a subsidy to Massachusetts diaries at the expense of out-of-state producers).
Seminal Cases – Discrimination Prong (Cont’d)

striking down a use tax because its rate exceeded the sales tax rate imposed on substantially equivalent transactions)

Fulton Corp. v. Faulkner, 516 U.S. 325 (1996) (Intangibles tax facially discriminated against interstate commerce, because tax liability could be reduced by taking a taxable percentage deduction equal to the fraction of the issuing corporation’s income subject to tax in North Carolina”).
Seminal Cases – Discrimination Prong (Cont'd)

*Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine, 520 U.S. 564 (1997)* (holding that an exemption from state property tax that was generally applied to the property of charitable organizations violated the Commerce Clause if organizations that served mostly out-of-state residents could only get a limited exemption).

Seminal Cases – Discrimination Prong (Cont'd)

Seminal Cases – Discrimination Prong (Cont’d)


About the Instructors

PHILIP M. TATAROWICZ, ESQ., CPA, is Of Counsel with Morrison & Foerster LLP, in Washington, D.C., and a Professor of Law and Distinguished Visitor From Practice at Georgetown University Law Center. Mr. Tatarowicz has over 35 years of experience advising major companies on tax-related matters. Prior to joining Morrison & Foerster and the faculty of Georgetown Law, he was at Ernst & Young, where he established that Big Four firm’s State and Local Tax group. Mr. Tatarowicz routinely provides tax advice to many of the world’s largest U.S.- and non-U.S.-based corporations doing business in virtually every major segment of commerce, including: industrial products; retail, consumer products, technology, communications, entertainment, energy, chemical, utilities, health sciences, financial services, real estate, hospitality, construction, aerospace, and insurance. His practice responsibilities include every type of state and local tax, with primary time spent on corporate income, property, payroll, sales and use, gross receipts, and other transaction based taxes. Mr. Tatarowicz is a recipient of the Institute for Professionals in Taxation®’s prestigious Special Recognition Award. The award recognizes significant contributions by the recipient over an extended period to the advancement of the field of state and local taxation. Mr. Tatarowicz has been active in various industry and SALT reform commissions, professional advisory boards, and other professional organizations where he has assisted in the crafting of legislative and administrative tax proposals and testimony at the Federal, state and local levels of government. He has served as an expert witness in various court proceedings, and has served as a technical consultant to various law firms responsible for litigating controversies involving SALT issues before select Federal and state courts. In addition to being the former chairman of the American Bar Association’s (ABA’s) Subcommittee on Interstate Transactions, Mr. Tatarowicz is Past Chair of the ABA’s Committee on State and Local Taxation; Past Chair of the Internal Revenue Service Advisory Council (IRSAC); Chair of its Large Business and International (LB&I) Subgroup; and, past IRSAC liaison to the IRS Office of Professional Responsibility Advisory Group. Mr. Tatarowicz serves on the State Tax Advisory Boards for several publishers, including Commerce Clearing House, Bureau of National Affairs, Panel Publications, Journal of Multistate Taxation, and Warren Gorham & Lamont. He is the Former chairman of the Subcommittee on Sales, Excise, and Miscellaneous Taxes of the Chicago Bar Association, the State Tax Committee of the District of Columbia Institute of CPAs, and the Tax Committee of...
the Chicagoland Chamber of Commerce. Mr. Tatarowicz has written numerous notes, commentaries and articles on a variety of multistate/multitax issues that have appeared in nationally distributed newspapers, magazines, professional journals, institute and symposia publications, and law reviews. He is a frequent chairman and speaker on state and local taxation to various professional groups both within and without the U.S. Mr. Tatarowicz has taught law at the Georgetown University Law Center for the last 33 years, and has served as a faculty advisor to its law review, The Tax Lawyer, and currently is the American Bar Association’s liaison to The Tax Lawyer – State and Local Tax Edition. Mr. Tatarowicz earned a BA in Accounting and Business Economics from Benedictine University, a JD from Northern Illinois University College of Law, and an LLM (Tax) from Georgetown University Law Center. He is member of the American Bar Association, and the American Institute of CPA.

CRAIG B. FIELDS, ESQ., is a partner at Morrison & Foerster LLP in New York and co-chair of the firm’s Tax Department as well as chair of the firm’s State & Local Tax Group. His practice focuses on litigation and planning relating to state and local tax matters. He has been involved in controversies regarding state and local tax issues before the administrative and judicial systems of jurisdictions throughout the United States as well as having resolved hundreds of non-public record cases around the country. Mr. Fields has also provided advice regarding the potential tax consequences of complex restructurings involving the corporation income (franchise) taxes, the sales and use taxes, and miscellaneous taxes of many jurisdictions. Mr. Fields is recommended as a leading state tax lawyer by Chambers USA, 2012 and 2013. He is recognized by Legal 500 US, 2011 – 2013, and has been consistently ranked in Super Lawyers since 2006. He has been named to State Tax Notes’ “Top 10 Tax Lawyers” list for 2011. Mr. Fields has written extensively in the area of state and local taxation. His articles have appeared in numerous publications, including Tax Management’s Multistate Tax Report, State Tax Notes, Research Institute of America’s State and Local Taxes Weekly, the COST State Tax Report, the Journal of State Taxation, the Journal of Multistate Taxation and Incentives, the Journal of New York Taxation, Interstate Tax Report, and the American Bar Association’s The State & Local Tax Lawyer. Mr. Fields is also a frequent lecturer concerning state and local taxes and has spoken before such organizations as New York University’s Institute on State and Local Taxation, Georgetown University Law Center’s Advanced State and Local Tax Institute, Vanderbilt University Law School’s Paul J. Hartman State and Local Tax Forum, the Council On State Taxation, the Institute for Professionals in Taxation, the Energy Tax Association, STARTUP, the Tax Executives Institute, the Tulane Tax Institute, the Practicing Law Institute, and the Tax Section of the American Bar Association. Mr. Fields is a member of the Georgetown Law Center Advisory Board and the Advisory Board for The Journal of State Taxation. Mr. Fields earned a BA degree in Accounting and Economics from Queens College, a JD degree from Duke University School of Law and an LLM in Taxation from New York University School of Law.
Glossary

The following definitions have been developed to facilitate an understanding of the course material. They tend to be generic in nature, and do not necessarily apply in any specific jurisdiction. In addition, the same terms may be defined differently in contexts other than those considered in the course material.

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td>Above The Line</td>
<td>Credits and Incentives that would provide a cash benefit or cash savings to the specific location or project’s operating budget.</td>
</tr>
<tr>
<td>Below The Line</td>
<td>Credits and Incentives that provide a tax credit that helps offset the company’s overall federal or state income/franchise taxes.</td>
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<tr>
<td>Benchmarking</td>
<td>To evaluate or check (something) by comparison with a standard.</td>
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<tr>
<td>Compliance</td>
<td>Generally refers to the functions performed to adhere to the sales and use tax laws, including but not limited to registration, filing of sales and use tax returns, and documentation of exemptions.</td>
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<tr>
<td>Exclusion</td>
<td>Two definitions:</td>
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<tr>
<td></td>
<td>(1) A transaction that is outside the general scope of the statutes imposing the sales or use tax. Common examples include real estate, stocks, bonds, and most services.</td>
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<tr>
<td></td>
<td>(2) An amount that is not included in the measure of sales and use taxes. Common examples include certain discounts, charges for freight, and charges for installation labor.</td>
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<tr>
<td><strong>Exemption</strong></td>
<td>A transaction that is within the general scope of the statutes imposing tax, but is the subject of special provisions removing it from taxation. Common examples include exemptions for charities, exemptions based on the nature of the product, and exemptions based on the use to be made of the product.</td>
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<td><strong>Headcount</strong></td>
<td>A total number of people in regard to a specific project, esp. the number of people employed in a particular organization.</td>
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<tr>
<td><strong>Person</strong></td>
<td>In sales and use tax, a distinct legal entity. Includes natural persons, corporations, partnerships, trusts, and others.</td>
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| **Real property** | Land and improvements to land. Includes tangible personal property that is incorporated into real property, and that meets the following tests:  
1. it is annexed, incorporated, or attached to land or other real property;  
2. the annexation, incorporation, or attachment is intended to be permanent; and  
3. it cannot be easily removed without causing substantial damage to the land or the other real property. |
| **Tangible personal property** | Property, other than real property, that can be held, smelled, touched, seen, tasted, or which is otherwise perceptible to the human senses. Excludes intangible property that is evidenced by tangible things, such as stocks, bonds and money. |
| **Use** | Commonly defined as the exercise of any right or power over tangible personal property incident to its ownership, other than the sale at retail. Can also be the enjoyment or the benefit of a taxable service. |