



# The Economics

## Introduction

Like most states, Michigan has a system of tax credits and exemptions that aims to increase investment and employment in Michigan. On October 19, 2004, however, the United States Court of Appeals for the Sixth Circuit (including Michigan, Ohio, Kentucky, and Tennessee) released an opinion that may affect those valuable business incentives.

The Sixth Circuit's decision in *Cuno*<sup>1</sup> is of particular importance to Michigan.<sup>2</sup> Over the past four years, Michigan has been one of the leaders in manufacturing job losses, and tax policy is often viewed as a viable mechanism for combating further losses.<sup>3</sup> This article examines whether and why Michigan's tax credits and exemptions fall under the rubric of *Cuno*.<sup>4</sup>

## *Cuno v DaimlerChrysler*

At issue in *Cuno* was a system of tax credits and property tax exemptions, totaling \$280 million, that were offered to defendant DaimlerChrysler as an incentive to expand its existing manufacturing facilities in Toledo.<sup>5</sup> At issue in this article is the system of franchise tax credits that the court found to be unconstitutional.

Ohio's investment tax credit granted a taxpayer a non-refundable credit against its corporate franchise taxes if the taxpayer "purchases new manufacturing machinery and equipment during the qualifying period, *provided that the new manufacturing machinery and equipment are installed in [Ohio]*."<sup>6</sup> Because the tax credit applied only to entities already subject to Ohio's franchise tax, it was available only to businesses already conducting business in Ohio.<sup>7</sup> Although the tax credit was generally limited to 7.5 percent of the cost of the machinery and equipment installed, the credit increased to 13.5 percent if it was installed in an economically depressed area.<sup>8</sup> Moreover, the credit was limited to \$1 million unless the taxpayer increased its total ownership of manufacturing equipment in the state during the year for which it claimed the tax credit.<sup>9</sup> Where the credit actually exceeded the taxpayer's franchise tax liability for the year, the balance of the credit was carried forward to subsequent years, but only for a maximum of three years.<sup>10</sup>

The court began by analyzing the franchise tax credit under Commerce Clause jurisprudence. According to the court:

*A tax provision satisfies the requirements of the Commerce Clause if (1) the activity taxed has a substantial nexus with the taxing State; (2) the tax is fairly apportioned to reflect the degree of activity that occurs within the State; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to benefits provided by the state.*<sup>11</sup>



## Are Beneficial Michigan Tax Incentives in Jeopardy after Sixth Circuit Court Ruling?

# of Business Attraction



BY JOSHUA S. SMITH  
AND JOHN D. MILLER



Based on the pleadings and the admissions of the parties, the only aspect of the test at issue was whether the tax credits discriminated against interstate commerce.

According to the court, a tax credit fails to pass constitutional muster if “it discriminates on its face, or if, on the basis of a ‘sensitive, case-by-case analysis of purposes and effects,’ the provision ‘will in its practical operation work discrimination against interstate commerce.’”<sup>12</sup> Such a tax credit runs afoul of the Commerce Clause unless it advances a “legitimate local purpose” that cannot otherwise be reasonably served.<sup>13</sup>

The plaintiffs argued that the tax credit discriminated against interstate commerce because it “coerced” businesses already doing business in Ohio—and thus already subject to its franchise tax—to expand within Ohio rather than another locale.<sup>14</sup> The discrimination arose because a company currently located in Ohio could reduce its tax liability only by locating new machinery and equipment in Ohio. A similarly situated company choosing not to locate new machinery and equipment in Ohio would thus face a greater comparative tax burden.<sup>15</sup>

The defendant argued that only those tax credits that penalized economic activity outside of Ohio could be deemed to have violated the Commerce Clause.<sup>16</sup> The Commerce Clause only prevented interstate protectionism; the tax credits at issue were constitutional, according to the defendants, because they did not penalize economic activity occurring outside of Ohio.<sup>17</sup>

The court agreed with the plaintiffs.<sup>18</sup> According to the court, the tax credits violated the Commerce Clause because they had the effect of encouraging “further investment in-state at the expense of development in other states,” which hindered “free trade among the states.”<sup>19</sup> Essentially, businesses already subject to the franchise tax were being coerced into expanding in Ohio rather than other states, and entities not already subject to the franchise tax received no tax incentive for locating in Ohio.<sup>20</sup>

### Michigan’s Business Incentives

Like many states in the midwest, Michigan has a panoply of business incentives to attract and keep new business in the state. These programs include the Michigan Renaissance Zone program,<sup>21</sup> the Certified Technology Park (Smartzone) program,<sup>22</sup> various environmental incentives,<sup>23</sup> property tax abatements for industrial property,<sup>24</sup> Empowerment Zones and Enterprise Communities,<sup>25</sup> and miscellaneous tax credits.<sup>26</sup>

Michigan, like Ohio and most other states, also has a system of tax credits and exemptions that aims to increase investment and employment in Michigan. Before delving into the specifics of these

tax credits, it may be helpful to take a look at the business tax regime in Michigan. Michigan imposes the single business tax (SBT) on the privilege of doing business in the state.<sup>27</sup> Strictly speaking, the SBT is not an income tax; rather, it is a *value added tax* that measures the increase in the value of goods and services brought about by the business itself between the time of purchase and time of sale.<sup>28</sup> The state levies the SBT on the value that a business has added to the state economy rather than only on the income the business has generated.<sup>29</sup> As a value added tax, the SBT applies not only to income, but also to depreciation, dividends, royalties, and compensation, among others.<sup>30</sup>

The business incentive system that is most susceptible to the rationale of *Cuno* is a system of tax credits, enacted in 1995, entitled the Michigan Economic Growth Authority Act (MEGA).<sup>31</sup> The legislative findings point to the purpose of MEGA:

*The legislature finds that it is in the public interest to promote economic growth and to encourage private investment, job creation, and job upgrading for residents in this state.*<sup>32</sup>

To qualify for MEGA credits, a business must satisfy several requirements:

- (a) *Except as provided in subsection (5), the eligible business creates 1 or more of the following within 12 months of the expansion or location as determined by the authority:*
  - (i) *A minimum of 75 qualified new jobs at the facility if expanding in this state.*
  - (ii) *A minimum of 150 qualified new jobs at the facility if locating in this state.*
  - (iii) *A minimum of 25 qualified new jobs at the facility if the facility is located in a neighborhood enterprise zone... [.] a renaissance zone... , or is located in a federally designated empowerment zone, rural enterprise community, or enterprise community.*
  - (iv) *A minimum of 5 qualified new jobs at the facility if the eligible business is a qualified high-technology business.*
  - (v) *A minimum of 5 qualified new jobs at the facility if the eligible business is a rural business.*
- (b) *Except as provided in subsection (5), the eligible business agrees to maintain 1 or more of the following for each year that a credit is authorized under this act:*
  - (i) *A minimum of 75 qualified new jobs at the facility if expanding in this state.*
  - (ii) *A minimum of 150 qualified new jobs at the facility if locating in this state.*
  - (iii) *A minimum of 25 qualified new jobs at the facility if the facility is located in a neighborhood enterprise zone... [.] a renaissance zone... , or is located in a federally designated empowerment zone, rural enterprise community, or enterprise community.*
  - (iv) *If the eligible business is a qualified high-technology business...*

- (A) A minimum of 5 qualified new jobs at the facility.  
 (B) A minimum of 25 qualified new jobs at the facility within 5 years... and a minimum of 25 qualified new jobs at the facility each year thereafter.
- (v) If the eligible business is a rural business...
- (A) A minimum of 5 qualified new jobs at the facility.  
 (B) A minimum of 25 qualified new jobs at the facility within 5 years...

Moreover, the average wage for the jobs created or retained must be at least 150 percent of the federal minimum wage; qualified high-technology businesses must pay an average wage of at least 400 percent of the federal minimum wage.<sup>33</sup> Large employers and distressed businesses must meet a separate set of requirements to receive a MEGA credit.<sup>34</sup> Therefore, to receive the credit, a business must create and maintain a minimum number of jobs paying at least a minimum average wage.

An entity may claim MEGA credits for no more than 20 years, although a distressed business may claim them for only three years.<sup>35</sup> The amount of the credit is generally equal to the amount of tax liability created by the authorized business activity.<sup>36</sup>

## Allying *Cuno* to MEGA

There are two possible readings of *Cuno*—a broad interpretation and a narrow one. Reading *Cuno* broadly, any state tax credit that encourages in-state rather than out-of-state investment would run afoul of the Commerce Clause because it would tend to “hinder free trade among the states.” This broad interpretation poses problems for Michigan because the MEGA credits encourage investment in Michigan rather than other states. The legislature specifically stated that to be the goal of MEGA.<sup>37</sup> In fact, a broad interpretation of *Cuno* would seemingly strike down the tax incentive schemes in place in every state because the sole purpose of offering such tax incentives is to entice investment in the state offering the credit rather than other states.

The broad reading of *Cuno* is by no means authoritative, however. Interpreting *Cuno* narrowly limits its application to state income tax credits for investment in manufacturing machinery and equipment installed in the credit-granting state. Additionally, *Cuno*'s prohibition would be limited to only those tax credits that apply to entities already conducting business in the credit-granting state.

*Cuno* itself hints that the narrow approach is the better interpretation. One of the central problems *Cuno* found with the Ohio tax credits, for instance, was that it applied only to entities already conducting business in Ohio and thus already subject to the franchise tax, essentially forcing Ohio manufacturers who wanted to expand to choose between increasing their comparative tax burden or

investing in Ohio.<sup>38</sup> The court also noted, in dicta, that direct state subsidies did not violate the Commerce Clause.<sup>39</sup> Most importantly, the court specifically held that the personal property tax exemption was constitutionally permissible because there are:

*fundamental differences between tax credits and exemptions. Unlike an investment tax credit that reduces pre-existing income tax liability, the personal property exemption does not reduce any existing property tax liability. The exemption merely allows a taxpayer to avoid tax liability for new personal property put into first use in conjunction with a qualified new investment. Thus, a taxpayer's failure to locate new investments within Ohio simply means that the taxpayer is not subject to the state's property tax at all, and any discriminatory treatment between a company that invests in Ohio and one that invests out-of-state cannot be attributed to the Ohio tax regime or its failure to reduce current property taxes... Additionally, the personal property tax exemption is internally consistent because, if universally applied, the new property would escape tax liability irrespective of location. Every new investment, no matter where undertaken, would be exempt from a tax.*<sup>40</sup>

Had the Sixth Circuit thought that all forms of tax relief for business expansion violated the Commerce Clause, it would not have found the property tax exemption to be constitutionally permissible.

Under the narrow interpretation of *Cuno*, most of the provisions of MEGA would likely pass constitutional muster because the MEGA tax credits are distinguishable from the Ohio tax credits at issue in *Cuno*. First, the SBT is a value added tax, unlike the Ohio franchise tax. Second, it is not a tax credit solely for investment in manufacturing machinery and equipment. It applies to any business investment that creates and maintains a certain level of employment that pays a minimum average wage, although large employers must also make a minimum capital investment in Michigan. Third, nothing in the act requires an entity to already be subject to the SBT; in fact, the requirement that the minimum employment level be created anticipates that businesses not currently present in Michigan or otherwise subject to the SBT can locate in Michigan and claim the credit.

This is not to say that no aspect of MEGA runs afoul of *Cuno*. There are at least two provisions in MEGA that may not fall under

the rubric announced in *Cuno*. First, in order to initially qualify for a MEGA credit, a facility located in Michigan must create and maintain 75 qualified new jobs, but a facility relocating to Michigan from another jurisdiction must create and maintain 150 qualified new jobs.<sup>41</sup> Thus, similarly situated businesses are treated differently based on whether they are already conducting business in Michigan. This does not constitute a clear violation of *Cuno*, however, as out-of-state businesses can still qualify for a MEGA credit. Moreover, insofar as it violates *Cuno*, the legislature could

## FAST FACTS



**Michigan, like Ohio and most other states, has a system of tax credits and exemptions that aims to increase investment and employment in Michigan.**



**Over the past four years, Michigan has been one of the leaders in manufacturing job losses, and tax policy is often viewed as a viable mechanism for combating further losses.**



**At issue in *Cuno* was a system of tax credits and property tax exemptions, totaling \$280 million, that were offered to defendant DaimlerChrysler as an incentive to expand its manufacturing facilities in Toledo.**

easily change the employment requirements so that they are identical for both in-state and out-of-state businesses.

Similarly, large employers who are already conducting business in Michigan have significantly less onerous capital investment requirements. An existing facility need only maintain 500 jobs and make a new capital investment of \$250 million to qualify for MEGA credits, but a relocating facility must also maintain 500 jobs and make a new capital investment of \$500 million.<sup>42</sup> Moreover, distressed businesses, which are required to have been conducting business in Michigan for at least four years, automatically meet the requirements of section 5 of MEGA.<sup>43</sup> This latter aspect of MEGA, however, arguably constitutes a “legitimate local purpose” that cannot otherwise be reasonably served.<sup>44</sup>



## Conclusion

Assuming that subsequent courts narrowly interpret *Cuno*'s holding, most provisions of MEGA seem to be constitutionally permissible. Businesses in Michigan have strong arguments should a Michigan court attempt to invalidate these important business incentives. No guarantee, however, can be made that courts will interpret *Cuno* narrowly. Because of the importance of the *Cuno* ruling, the danger that courts may not interpret it narrowly, and the severe competitive disadvantage created for states within the Sixth Circuit, *Cuno* needs to be addressed by the United States Supreme Court. Otherwise, different standards among different federal circuits will wreak regional economic havoc. Accordingly, a uniform national standard must, and hopefully will, be set by the United States Supreme Court.<sup>45</sup> ♦



*Joshua S. Smith is an attorney in the litigation group of Fraser Trebilcock Davis & Dunlap, P.C. in Lansing, Michigan. He holds a J.D. from the University of Michigan (2001), an M.A. from Michigan State University (1998), and a B.A. from Oakland University (1995).*



*John D. Miller is an attorney in the business group of Fraser Trebilcock Davis & Dunlap, P.C. in Lansing, Michigan. He holds an L.L.M. in taxation from New York University (2001), a J.D. from the University of Toledo (2000), and a B.B.A. in finance from Eastern Michigan University (1996).*

## Footnotes

- 386 F3D 738 (CA 6, 2004).
- The Granholm administration has acknowledged the potential importance of *Cuno*. See “Ohio tax credit struck down,” Sarah A. Webster, *Detroit Free Press*, September 3, 2004.
- “State offers GM, German supplier, tax breaks to retain manufacturing jobs,” *Associated Press*, March 18, 2004.
- At least one observer, Michael LaFaive from the conservative Mackinac Center for Public Policy, has concluded that the Michigan tax credits are unconstitutional under *Cuno*. Sarah A. Webster, *Detroit Free Press*, September 3, 2004;

- “U.S. court overturns Jeep plant tax credit,” Jim Provance, *Toledo Blade*, September 3, 2004. As shown in this article, however, LaFaive’s conclusion was premature and misinformed.
- See Slip Op, at 2. The court held that the property tax exemption was constitutional and is not further discussed in this article.
  - Ohio Rev Code Ann 5733.33(B)(1). Emphasis added.
  - See Slip Op, at 2. See also Ohio Rev Code Ann 5733.33(B)(1).
  - See Ohio Rev Code Ann 5733.33(C)(1), (2), (A)(8)–(13).
  - See Ohio Rev Code Ann 5733.33(B)(2)(a).
  - See Ohio Rev Code Ann 5733.33(D).
  - Slip Op, at 3. Internal citations omitted.
  - Id.*, quoting *West Lynn Creamery v Healy*, 512 US 186, 201 (1994).
  - Slip Op, at 3, quoting *Oregon Waste Syst, Inc v Dep’t of Environmental Quality*, 511 US 93, 101 (1994).
  - See Slip Op, at 3–4.
  - Id.*
  - See Slip Op, at 5.
  - Id.*
  - See Slip Op, at 6.
  - See Slip Op, at 5. Notably, the court held that direct subsidies of economic activity did not violate the Commerce Clause. *Id.*
  - See Slip Op, at 5–6.
  - See MCL 125.2681 to 125.2696. See also MCL 211.7ff.
  - See MCL 125.2151 to 125.2174.
  - These programs include: (1) the Michigan Brownfield Redevelopment Project, MCL 125.2651 to 125.2672, MCL 208.38d, IRC 198; (2) the Michigan “Clean Corporate Citizen” designation, Mich Admin R 336.2401; and (3) tax incentives associated with the purchase and operation of environmental pollution control equipment, MCL 205.54a, IRC 169.
  - See MCL 207.551 to 207.572.
  - See MCL 125.2561 and 125.2601. See also IRC 1391.
  - These tax credits include: (1) the Historic Preservation Tax Credit, MCL 208.39c; (2) the Obsolete Property and Rehabilitation Property Tax Credit, MCL 125.2781 to 125.2797; (3) the SBT Investment Credit, MCL 208.35a; (4) the SBT Technology Credit, MCL 208.37b; (5) the Industrial Processor Sales Tax Exemption, MCL 205.51 and 205.54a; and (6) exemption for special tools, MCL 211.7 to 211.7z.
  - See *Columbia Associates, LP v Department of Treasury*, 250 Mich App 656, 666–667; 649 NW2d 760, lv den 656 NW2d 520 (2002).
  - See MCL 208.31(3); *Mobile Oil Corp v Dep’t of Treasury*, 422 Mich 473, 493; 373 NW2d 730 (1985).
  - Id.*
  - See MCL 208.9(4)(c); MCL 208.9(5).
  - See MCL 207.801. MEGA was enacted as PA 1995, No. 24.
  - MCL 207.802.
  - See MCL 207.808(1)(d).
  - MCL 207.808(1). Internal citations omitted.
  - See MCL 207.208(2).
  - See MCL 208.37c; MCL 208.37d; and MCL 208.38g. See also *2002 Guidebook to Michigan Taxes*, Samuel J. McKim III, Robert F. Rhoades and Joanne B. Faycurry, eds. (CCH, 2001), at 127.
  - See MCL 207.802.
  - See Slip Op, at 5–6.
  - See Slip Op, at 6.
  - Slip Op, at 7. Internal citations omitted; emphasis added.
  - See MCL 207.808(1)(a), (b).
  - See MCL 207.808(5).
  - See MCL 207.803(f); 207.808(5)(c).
  - See *Maine v Taylor*, 477 US 131, 138–139, 151 (1986); *Sporhase v Nebraska ex rel Douglas*, 458 US 941, 958 (1982).
  - By no means has the *Cuno* saga ended. A group of senators, including Michigan’s Debbie Stabenow and Carl Levin, have proposed a bill to allow states to grant the types of tax breaks disallowed in *Cuno*. “Bill to protect tax break bids,” *The Detroit News*, May 19, 2005, at C1. The bill, the Economic Development Act of 2005, was introduced in the United States Senate on May 18, 2005 as S 1066 IS.
- In addition, three petitions for a writ of certiorari have been filed. See *Cuno, et al. v DaimlerChrysler Corporation, et al.*, United States Supreme Court Docket No. 04-1407, April 20, 2005; *DaimlerChrysler Corporation, et al. v Cuno, et al.*, United States Supreme Court Docket No. 04-1704, June 20, 2005; and *William W. Wilkins, Tax Commissioner for the State of Ohio, et al. v Cuno, et al.*, United States Supreme Court Docket No. 04-1724, June 22, 2005.