

# Sixth Circuit Declares Ohio's Manufacturing Tax Credit Unconstitutional

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On September 2, 2004, a three judge panel of the U.S. 6th Circuit Court of Appeals placed at risk one of Ohio's most important tools used to generate economic development within the state, when it held in *Cuno v. DaimlerChrysler*<sup>1</sup>, that Ohio's investment tax credit violated the Commerce Clause of the U.S. Constitution because it discriminates against interstate commerce. The case was brought as a deliberate attack and challenge to state incentive programs. It was filed by a small group of individuals and small businesses, initiated by independent presidential candidate Ralph Nader. This lawsuit was part of a broader effort by Nader and his supporters to challenge financial incentives for corporations.<sup>2</sup>

## Background and Case Update

In 1998, the City of Toledo and DaimlerChrysler, Inc. entered into an agreement pursuant to which DaimlerChrysler agreed to build a new automobile assembly plant in the city in exchange for a 13.5% corporate franchise tax investment credit, along with several other economic tax incentives. The total value of the tax incentives was estimated at \$280 million.<sup>3</sup>

Ohio provides for a non-refundable investment tax credit against the state's franchise tax to businesses that "purchase new machinery and equipment...provided that the new manufacturing machinery and equipment is installed in the state of Ohio."<sup>4</sup> It is estimated that business owners in the aggregate have invested over \$30 billion in Ohio in reliance on the investment tax credit.<sup>5</sup>

There were 15 individuals plaintiffs and three small business plaintiffs in the case. The plaintiffs lost in federal district court. On appeal, the plaintiffs challenged the investment tax credit on the grounds that it violated the Commerce Clause, in that it discriminates against interstate commerce by favoring in-state over out-of-state business expansion.

The Court agreed with the plaintiffs' argument, stating:

"Any corporation currently doing business in Ohio, therefore paying the state's corporate franchise tax in Ohio, can reduce its existing tax liability by locating significant new machinery and equipment within the state, but it will receive no such reduction in tax liability if it locates comparable plant and equipment elsewhere."<sup>6</sup>

The Court also recognized the plaintiffs' claim that "...the economic effect of the Ohio investment tax credit is to encourage further investment in-state at the expense of development out-of-state and...the result is to hinder free trade among the states."<sup>7</sup> The Court ruled that, even though it was sympathetic to Ohio's economic need to attract new business investment and development, the investment tax credit violated the Commerce Clause because it was not equally available to in-state and out-of-state business expansion.<sup>8</sup>

The Court distinguished a tax credit from a government subsidy. In the latter case, a business pays full taxes but receives a government grant in return for doing business in the state. The Court stated:

"Although the defendants liken the investment tax credit to a direct subsidy, which would no doubt have the same economic effect...the distinction between a subsidy and a tax credit, in the constitutional

sense, results from the fact that the tax credit involves state regulation of interstate commerce through its power to tax.”<sup>9</sup>

The Ohio Attorney General’s Office filed a petition for review by the full panel of twelve judges of the 6th Circuit. However the petition was denied on January 18, 2005, by order of the Court. The order issued by the Court noted that it had received three petitions for a rehearing of the earlier ruling and that all active judges, absent one who recused himself, reviewed the petition and less than the majority favored the suggestion for rehearing.

On the Congressional front, two Ohio Senators, along with a Kentucky House Representative, who has a similar incentive, have introduced new legislation designed to overrule the 6<sup>th</sup> Circuit’s decision in *Cuno*.<sup>10</sup> Both bills have been referred to committee and are awaiting further action.

### **Impact of the Decision**

The 6th Circuit’s decision involves only Ohio’s investment tax credit under the franchise tax system. However, the Court’s rationale could be expanded to any tax credit that is premised upon further economic activity in Ohio. Similar type credits can be found throughout Ohio’s personal and business tax structure. Under the *Cuno* decision, all of these credits could be unconstitutional as a violation of the U.S. Constitution’s Commerce Clause. Because the decision was issued by the 6th Circuit, it applies not only to Ohio, but also to Kentucky and Michigan, putting similar tax credits in those states in question as well.

Furthermore, if the decision is appealed and upheld by the U.S. Supreme Court, all similar credits offered by all states could be in jeopardy. As this was a test case for Ralph Nader, it is likely that a positive outcome in *Cuno* will lead to suits in other states as well. In fact, at least one lawyer independent of Nader, has filed suit on grounds similar to *Cuno* in Nebraska.<sup>11</sup>

### **Future Filings**

The decision is prospective in nature and will apply only to franchise returns filed after the date of the Court’s decision. However, because a review of the decision is being made, Ohio is not currently enjoined from administering the investment tax credit and is currently allowing taxpayers to claim the credit in those circumstances where purchases of new manufacturing machinery and equipment qualify for the credit under Ohio law. Alternatively, businesses may file their corporate tax returns without the investment tax credit and file a protective refund claim to protect the refund in the event that the *Cuno* decision is overturned by the U.S. Supreme Court or legislatively changed.

### **Additional Actions**

The Ohio Attorney General’s Office has publicly stated that it is planning to appeal the decision to the U.S. Supreme Court. The petition for review must be filed by April 19, 2005. However, the review is discretionary and could be denied. If accepted, it is likely several months away before a decision is reached. In the meantime, it is recommended that businesses consider taking the following actions to determine the full impact of the *Cuno* decision:

- Identify the tax benefits associated with tax credits similar to Ohio’s investment tax credits in all states in which the business is considered doing business;
- Consider taking protective measures in states where there are significant tax credit benefits at

risk;

- Determine potential methods to renegotiate existing credit arrangements to ensure they do not violate the Commerce Clause;
- Review and revise new tax credits in the process of being negotiated so they will not be vulnerable to constitutional attack; and
- Analyze the full potential tax and financial statement impact of the *Cuno* decision.

*2004 Fed. App. 0293P (6th Cir.)*

*Detroit Free Press, "Ohio Tax Credit Struck Down", September 3, 2004*

*Cuno, 2004 Fed. App. 0293 (6th Cir.)*

*Ohio Rev. Code Ann. §5733.33(B)(1)*

*See Defendants Petition for Rehearing (6th Cir.). See also, [www.ag.state.oh.us/columns/2004/20041006.htm](http://www.ag.state.oh.us/columns/2004/20041006.htm).*

*Cuno, 2004 Fed. App. 0293 (6th Cir.)*

*Id.*

*Id.*

*Id.*

*See S. 2881 and H.R. 5427. Both are bills to clarify that State tax incentives for investment in new machinery and equipment are a reasonable regulation of commerce and not an undue burden on interstate commerce, and for other purposes.*

*DeCamp v. Nebraska, No. CI041981*

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