FOCUS ON CORPORATE REAL ESTATE

A Taxing Decision: Here, There…Everywhere?

BY JEFFREY L. ELIE

DR. SEUSS WROTE DOZENS OF CHILDREN'S BOOKS that tell us the world is not necessarily logical, nor does it always work the way we expect it to. That's why when the Sixth Circuit Court of Appeals struck down the longstanding and widespread practice of states giving businesses certain kinds of tax incentives to create local jobs, corporate real estate professionals could have been forgiven for turning Seussical with exasperation. To quote *One Fish, Two Fish, Red Fish, Blue Fish*: "From there to here, from here to there, funny things are everywhere."

The quote seems particularly apt because, for the moment, the court ruling has left us in limbo—uncertain about where or when or how the tax incentive decision will come into play. Among the possibilities:

- Now that the U.S. Supreme Court has accepted the Cuno case, a decision affirming the Sixth Circuit ruling would make it the law of the land; a rejection of the Sixth Circuit reasoning would bring us back to where we were when the case started.
- The decision could be limited to Ohio, Kentucky, Michigan and Tennessee, the four states covered by the Sixth Circuit Court, which has stayed the implementation of its ruling until appeals play out. The full appeals court has refused to reconsider the issue, leaving the U.S. Supreme Court as the next level of appeal. If the Supreme Court refuses to take up the matter, the decision will stand—but only for the four states.
- Congress may render the court process moot. Bills have been introduced that will specifically empower states to offer these types of tax incentives. A GOP-dominated legislative branch and a business-friendly executive branch may well see this as the best solution.

How did we get to this point? The story begins in 1998 with the state of Ohio, the city of Toledo and two school districts using tax incentives to entice DaimlerChrysler to build a new vehicle assembly plant near its existing facility in Toledo. DaimlerChrysler estimated it would spend $1.2 billion on the project and bring several thousand new jobs to the area. The city and school districts agreed to forego collecting all property taxes on the project for 10 years; the state kicked in a 13.5 percent investment tax credit to off-set DaimlerChrysler's state corporate franchise tax, based on the purchase of new manufacturing equipment and its installation in an Ohio plant. The combined tax incentives were valued at $281 million.

There was little unusual about the package, except perhaps for its size. Across the country, cities, counties and states engage in similar deals to demonstrate to businesses that

About our Featured Columnists

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the jobs and economic stimulus they bring are valued. And in this case, Ohio seems to have struck a bargain that worked. The plant opened in 2001, employing about 3,800 workers.

The package was challenged in a lawsuit initiated by then-presidential candidate Ralph Nader, who said he opposed the use of subsidies and incentives by state and local governments to attract or retain businesses and jobs. Formally filed by a dozen taxpayers and three small businesses, the suit—Cuno v. DaimlerChrysler—argued that both the tax credit and the property tax abatement violated the Commerce Clause of the U.S. Constitution by favoring in-state over out-of-state business expansion.

Cuno was rejected by the first court to hear it. However, on October 19, 2004, a three-judge panel of the Sixth Circuit Court of Appeals overruled the lower court with regard to the tax credit. The judges agreed with the lower court and rejected the plaintiffs' argument on the property tax abatement issue, finding such a subsidy constitutional since it is well established in law that a state may use its collective wealth to benefit the local economy. This form of tax abatement is an enticement that can be offered to any business, whether they are within or outside the state.

But the tax credit offset for DaimlerChrysler is seen by the court as completely different because it reduced the company's existing franchise tax liability. That meant DaimlerChrysler could only reap the benefit if it developed its facility in Ohio, making the investment tax credit an inducement that hindered expansion of trade outside of the state. Such a tax credit was not equally available to in-state and out-of-state business expansion.

Since the Sixth Circuit ruling, experts have weighed in on each side. Some find the decision a completely rational determination of the issues ("The decision of the Sixth Circuit in Cuno is well-reasoned and is consistent with Supreme Court precedent applicable to discriminatory taxation…The focus should be on encouraging local businesses and out-of-state businesses to invest in the state by giving them an exemption from a new tax liability on land or personal property that will be used in their in-state business or a direct subsidy from their in-state businesses paid from general funds."). Others see angels dancing on the heads of pins when the court applies one set of reasoning to direct subsidies such as the allowed property tax abatement and a different one to indirect benefits such as the tax offset ("Making a distinction between subsidies and tax incentives seems highly formalistic since subsidies can, in practice, discriminate against interstate commerce in precisely the same manner as tax incentives… Federal courts certainly have a role to play in protecting interstate commerce from state intrusion, but curtailing the ability of states to raise or cut taxes, indeed to compete for business investment, is antithetical to the spirit of the Commerce Clause itself.").

One overriding point: we're not on corporate welfare, contrary to popular claims. Most states have required "call back" programs where companies that do not meet projected employment and investments levels must pay back the incentives. There are many examples of these on the books nationally, especially in weaker economic times.

From a real estate professional's point of view, the legalities and final outcome are in other's hands. The concern that the decision raises, however, is that there is no longer certainty about the rules of the game. That has a ripple effect not only across the United States but also globally, as businesses strive to remain competitive in a worldwide market. CoreNet Global, an association of 7,500 executives who manage more than $1.2 trillion worth of corporate real estate, has already begun to examine the unintended consequences.

In an informal survey conducted in early 2005, the CoreNet Global membership predicted an impact not only on existing facilities with similar incentive packages but also on future projects already in the pipeline. According to the survey, 35 percent say they plan to ask states and localities to refine their incentive programs so they can withstand a court challenge; 29 percent say their companies may re-evaluate location decisions for upcoming projects; and 32 percent say their plans will go forward unchanged, with factors other than incentives playing a larger role in the decision-making process.

That adds up to nearly two-thirds of the membership who see an adverse impact if and when the ruling takes hold. With state incentives responsible for a massive amount of economic development, the potential impact is immense. Possible effect: an increase in the rate of outsourcing of jobs and functions overseas. All-but-certain outcome: a huge increase in the cost of expanding operations in the United States.

The proof is in the statistics. Statements from Ohio officials indicate that more than 16,000 companies have applied for the investment tax credit since 1995, claiming more than $1.9 billion in credits. By some counts, roughly

two-thirds of the states in the nation offer some type of investment tax credit, each of which may or may not be affected by a final decision on Cuno, depending on how they are structured. The cumulative impact is difficult to determine—but it is not inconsequential at a time when businesses reckon their costs carefully before proceeding with expansion.

Furthermore, Cuno raises questions about a whole host of other incentive programs, including:

■ The Keystone Opportunity Zone (KOZ) in Pennsylvania. Since the program began in 1999, more than $5 billion has been invested, 43,000 jobs have been created or retained—all the result of the waiver of millions of dollars in state and local taxes. In addition, PECO is offering reduced electrical rates to businesses that move into a KOZ from outside the state or outside existing PECO territory—an incentive not available to businesses already PECO customers.

■ The Michigan Economic Development Corp. awarded $128 million in single-business tax credits last year through the Michigan Economic Growth Authority (MEGA). Some critics of MEGA, which they say discriminates against the many businesses that do not receive tax relief, believe the program is so similar to Ohio's that MEGA would be eliminated; others believe that the program would be permissible.

■ Pennsylvania's Research and Development Tax Credit is offering businesses that expand their research and development function within the state a credit against their tax liability that carries forward to the next year.

■ In Kentucky, a plant manufacturing stainless steel products has agreed to a $75 million expansion there, with industrial revenue bonds issues by the state a key incentive for the decision.

The International Economic Development Corporation has weighed in on the issue, cautioning that in our globally competitive world market, the states are not just competing against themselves for business. Their official statement: "The opportunity to offer tax incentives to businesses looking to grow or relocate is a valuable economic development tool. Tax incentives allow states, regions and communities to vie for business in our globally competitive world market."

There remain many unanswered questions. So as Dr. Seuss no doubt would say, let us end where we began. From there to here, from here to there, funny things are everywhere. Despite the uncertainty reflected in our whimsical Seuss quote, real estate professionals will continue to move forward, helping their companies make location and expansion decisions that are based on tangible benefits: the lowest capital investment costs, the broadest labor availability, the best quality of life—and the most competitive, legally solid package of incentives they can bargain for. While the courts and politicians consider where to go with Cuno, the strategic real estate advisor will simply add this taxing decision to the already complex set of factors that need to be considered. ■