WESTINGHOUSE ELECTRIC CORP. V. TULLY

AND CONSTITUTIONALITY OF MINNESOTA'S BUSINESS TAX CREDITS

A Legal Analysis

March 1985

Research Department
Minnesota House of Representatives

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In the 1984 case, Westinghouse v. Tully, the Supreme Court for the first time held that a tax credit provided as part of an otherwise fairly apportioned state corporate income tax unconstitutionally discriminated against interstate commerce. This memorandum analyzes the constitutionality of the Minnesota tax credits in light of Westinghouse and further explores legislative alternatives to the present tax credit.

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SUMMARY/CONCLUSION

Many states, including Minnesota, make extensive use of income tax credits to provide incentives for in-state business investment and expansion. In Minnesota credits are provided for a portion of the cost of research and development, equity investments in small businesses, and pollution control equipment. These credits are limited to activities in Minnesota. As investment or expenditures in Minnesota increase, the credits reduce the business's effective Minnesota tax rate. Conversely, if the business engages in the same activities outside of Minnesota, its effective tax rate remains unchanged. Thus, the credits provide an inducement for in-state expansion and an implicit penalty for out-of-state expansion.

The commerce clause of the federal constitution prohibits state taxation which discriminates against interstate commerce or out-of-state businesses. In the context of income taxation of multistate corporations the U.S. Supreme Court generally has held that if the tax was fairly apportioned, it was also nondiscriminatory. However, in a recently decided case, Westinghouse Electric Corporation v. Tully,[*] the Court held that a New York income tax credit for a corporation's DISC[**] exports unconstitutionally discriminated against interstate commerce, even though the underlying New York tax was fairly apportioned.

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[*] 104 S.Ct. 1856 (1984).

[**] Domestic international sales corporations (DISCs) are corporations that qualify for a now repealed federal tax incentive for exports. See I.R.C. §§991 et seq. (1984).

The New York DISC credit in <u>Westinghouse</u> was computed by multiplying the corporation's income qualifying for federal DISC deferral by, among other things, the percentage of the corporation's DISC income that was derived from New York. As a result, the greater the proportion of DISC exports made from New York, the larger the tax credit and the lower the New York tax. If the corporation shifted more of its DISC exporting activities out of New York, the in-state percentage would go down, reducing the credit and increasing the tax. Thus, the credit rewarded businesses that did more of their DISC exporting from New York and penalized businesses that did more of their DISC exporting from other states or shifted more of their DISC exporting to other states. This, the Court held, unconstitutionally discriminated against interstate commerce.

The primary Minnesota business tax credits--the research and experimental expenditure, equity investment, technology transfer, and pollution control credits--are similar in their effect to the <u>Westinghouse</u> DISC credit. Each of the credits provides tax reductions as the taxpayer increases its activities or investment in Minnesota. As a result, taxpayers' Minnesota effective tax rates decline as they increase their in-state investment or expenditures.

Although it is not completely clear, Minnesota research, equity investment, and technology transfer credits appear to be unconstitutional under the rationale of the <u>Westinghouse</u> case. They suffer from the same defect as the New York DISC credit; lower effective tax rates are provided as in-state investment or expenditures increase. However, the Minnesota credits differ from the New York DISC credit in one important way. The Minnesota credits are based on the absolute amount of in-state investment or activity. In-state activity is the sole determinant of the credit amount. By contrast, the New York credit was calculated in a manner that caused a corporation's credit to decline and tax to rise if the out-of-state share of total DISC exports increased. The Court noted that this effect of the credit was especially odious. While the language of the opinion does not precisely indicate whether this feature of the New York credit was critical in deciding its constitutionality, it implies that it was not the deciding factor.

The remaining Minnesota business credits, unlike the research and investment credits, probably are constitutional. The pollution control credits would likely be upheld as compensating for the more stringent pollution control regulations imposed by Minnesota. The resource recovery facilities credit is not limited to facilities which are located in Minnesota or which process Minnesota waste. Therefore, the credit does not discriminate against out-of-state businesses or interstate commerce. Similarly, the credit for purchases of conservation tillage equipment is not restricted to equipment used in Minnesota and would not therefore be discriminatory.

The Legislature has four options for dealing with the potentially unconstitutional tax credits:

(1) The discriminatory features of the tax credits could be eliminated by repealing the requirement that qualifying investments or expenditures be made in the state. The resulting credits could be apportioned using the business's Minnesota apportionment formula to ensure that the credits were allowed in proportion to the corporation's Minnesota income. Since the apportionment formula is based on the corporation's property, payroll and

sales, not the preferred activities, this approach would eliminate the incentive effect of the credits. The credits would no longer encourage businesses to locate or expand in Minnesota, if that was the principal goal of the Legislature in enacting the credits. Rather they would simply encourage the businesses to increase the amount of the preferred activities conducted world-wide.

(2) The credits could be left intact. It may be that the Court will retreat from the more expansive implications of Westinghouse and permit state tax credits that do not contain all of the discriminatory features of the New York DISC credit. The risk to the state of a revenue loss resulting from the loss of a lawsuit contesting the validity of the tax credits may not be too great. If the appropriate remedy is to invalidate the entire credit, the state could actually realize a revenue gain as a result and the businesses would have a reduced incentive to challenge the credits. Alternatively, if the appropriate remedy is to invalidate only the discriminatory features of the credits (i.e., the restriction to Minnesota-based activities), the state could suffer a significant revenue loss. The available authority suggests that the courts would likely invalidate the entire credits, rather than just the discriminatory features. The specific results will probably depend upon the facts and circumstances surrounding each credit. Furthermore, the Legislature may be able to reduce the risk of a revenue loss by explicitly limiting the remedies available to taxpayers contesting the constitutionality of the credits.

(3) The credits could be repealed and replaced with direct spending (grant) programs designed to obtain the same objectives. A line of recent

Supreme Court cases has held that when a state acts as a "market participant" rather than imposing taxes or regulations, it is permissible to discriminate in favor of local businesses. State grant programs designed to mirror the effects of the tax credits may qualify as market participation. Although the definition of market participation is not very clear, it appears unlikely that the converted tax credit-grant programs would qualify as market participation. Unlike the programs upheld by the Court as market participation, the grant programs would be neither traditional governmental activities, nor the standard sorts of proprietary activities undertaken by state and local governments. The discrimination in favor of local businesses would be the primary objective and purpose of the programs, rather than a side effect of a program with another predominant governmental purpose. As a result, the discriminatory effect is likely to be considered more pervasive.

(4) Finally, the Legislature could simply repeal the credits and lower the corporate tax rate by an offsetting amount. This would be simple and straightforward, but would not serve the function of providing special tax incentives for in-state expansion and investment or for increases in the preferred activities generally.

INTRODUCTION

Minnesota provides a variety of tax incentives to encourage businesses to invest and expand employment within the state. Minnesota law provides, for example, income tax credits for increased research expenditures in Minnesota, equity investment in small Minnesota businesses, and the cost of pollution control equipment used in Minnesota. The common thread characterizing these provisions is that as the business increases its investment or activities in Minnesota, its effective state income tax rate declines. Thus, even though the business's apportioned Minnesota income increases, the percentage of that income paid in state tax declines. Supporters of these provisions hope that the tax benefits will induce businesses to locate or expand in Minnesota or, at least, that the tax benefits will offset the incentive to expand or locate in other, lower tax states.

The commerce clause of the United States Constitution was intended to foster free trade among the states, while permitting states substantial autonomy within a system of federalism. To strike a balance between these competing and somewhat conflicting goals, the Supreme Court has held that the commerce clause prohibits state taxation that discriminates against interstate commerce, but permits states to structure their "tax systems to encourage the growth and development of intrastate commerce and industry."[1] For example, state taxes that levied higher rates on interstate or out-of-state transactions as compared with in-state or purely local transactions are unconstitutionally discriminatory.[2]

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[1] Boston Stock Exchange v. State Tax Commission, 429 U.S. 319, 336 (1977).

[2] Maryland v. Louisiana, 451 U.S. 725 (1981).

By contrast, if an income tax has a fair and internally consistent apportionment formula, it is generally held to be nondiscriminatory even if the formula favors local manufacturers who sell their goods in other states.[3]

In the 1984 case, Westinghouse v. Tully,[4] the Supreme Court for the first time held that a tax credit provided as part of an otherwise fairly apportioned state corporate income tax unconstitutionally discriminated against interstate commerce. Westinghouse provides new insight into the constitutional limits on the state income taxation of multi-jurisdiction businesses and on the use of income tax credits to stimulate in-state business expansion. If followed and expanded, Westinghouse may indicate a new direction in these constitutional limits and certainly has important implications for the constitutionality of a variety of Minnesota's tax credits and other preferences. This memorandum analyzes the constitutionality of the Minnesota tax credits in light of Westinghouse and further explores legislative alternatives to the present tax credits.

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[3] Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978). The apportionment is not constitutional, however, if it is "out of all appropriate proportion to the business transacted" in the state, despite being fair and internally consistent on its face. Id. at 274, citing Hans Rees" Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123, 135 (1931).

[4] 104 S.Ct. 1856 (1984).

DISCUSSION

I. PREFERENTIAL TAX CREDITS AS DISCRIMINATION AGAINST INTERSTATE COMMERCE

A. General Test

In reviewing the constitutionality of state taxation of interstate commerce, the Supreme Court has applied a four part test. Under this test a tax is unconstitutional if (1) the business activity being taxed does not have sufficient nexus with the taxing state; (2) the tax is not fairly apportioned; (3) the tax discriminates against interstate commerce; or (4) the tax is not fairly related to the services provided by the state.[5]

The prohibition of discriminatory state taxes has been a fundamental and longstanding part of the constitutional doctrine.[6] If on its face the tax discriminates against interstate commerce, the finding is more or less conclusive as to the tax's unconstitutionality. There are limited exceptions to this. A differential tax on interstate commerce may be constitutional if it compensates for another tax that is levied on local businesses or local transactions and not on interstate commerce. For example, the Court has upheld a use tax levied on residents' in-state use of goods that were purchased out-of-state and were therefore exempt from the state sales tax.[7]

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[5] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

[6] Welton v. Missouri, 91 U.S. 275 (1876).

[7] Henneford v. Silas Mason Co., Inc., 300 U.S. 577 (1937). See also Alaska v. Arctic Maid, 366 U.S. 199 (1961) (differential license tax on out-of-state freezer ships upheld to compensate for higher tax on local canneries).

Because these tax schemes provide for equal treatment of local and out-of-state businesses, these exceptions would seem to more appropriately be considered part of the definition of discrimination, rather than exceptions to it.

B. What Constitutes "Discrimination"?

1. In General

Under the Court's standard formulation, a tax is unconstitutionally discriminatory if it provides "a direct commercial advantage to local business."[8] A tax that penalizes interstate commerce by imposing an additional tax or a higher tax rate on interstate businesses or transactions is unconstitutionally discriminatory.[9] Conversely, a tax is also unconstitutional if it favors some or all local businesses by providing exemptions, lower rates or other preferential provisions that disadvantage their interstate competitors.[10] It makes no difference that the discrimination is among different types of interstate transactions.[11] In evaluating whether the tax favors local business, the Court normally relies upon the characteristics of the tax, on its face, and on the economic structure of the industry, rather than economic analyses of actual tax burdens.[12]

As discrimination doctrine has developed two distinguishable standards or lines of cases appear to have emerged: one for transaction taxes and a second for

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[8] Boston Stock Exchange v. State Tax Commission, 429 U.S. 318, 329 (1977).

[9] Armco Inc. v. Hardesty, 104 S.Ct. 2620 (1984).

[10] Boston Stock Exchange v. State Tax Commission, 429 U.S. 318 (1977).

[11] Id.

[12] See Tribe, American Constitutional law, 358 (1978). Cf. Armco Inc. v. Hardesty, 104 S.Ct. 2620, 2625 (Rehnquist dissenting; arguing against reliance on hypothetical tax burdens).

net income taxes. Each will be discussed in turn. Finally, the effect of Westinghouse which applied rules developed in transaction tax cases to a net income tax credit will be examined.

2. Transaction Taxes

In Boston Stock Exchange v. State Tax Commission,[13] New York state levied a stock transfer tax on all securities transactions, whether the sale that generated the transfer was made in or out of the state. The tax provided, however, for a 50 percent reduction for nonresidents if the sales were made in New York and also provided a maximum tax for transactions involving New York sales. The result was that sales made outside of New York did not qualify for these preferential provisions but were nevertheless subjected to the tax when the securities were transferred through an exchange located in New York.[14] The Supreme Court held that the New York transfer tax unconstitutionally discriminated against interstate commerce. In the Court's words the tax "forecloses tax-neutral decisions and creates both an advantage for exchanges in New York and a discriminatory burden on commerce to its sister states."[15]

In Maryland v. Louisiana,[16] the Court reached a similar result. Louisiana levied a tax on the "first use" of natural gas imported into the state. A credit against the tax was provided for severance taxes paid to other states. However, nearly all of the gas was offshore outer continental shelf (OCS) gas which would not be subject to any state severance taxes. Furthermore,

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[13] 429 U.S. 318, 321.

[14] Id. at 324-25.

[15] Id. at 331.

[16] 451 U.S. 725 (1981).

through a series of credits and exemptions Louisiana consumers and businesses effectively escaped taxation.[17] Thus, the tax was imposed primarily on OCS gas that was transported through Louisiana for use in other states. The Court held that the first use tax "unquestionably discriminates against interstate commerce in favor of local interests as the necessary result of various tax credits and exclusions."[18]

As indicated above, a transaction tax which imposes a differential tax on interstate commerce may be upheld if it qualifies as a compensatory tax. For example, a use tax to ensure that purchases of goods out-of-state do not escape the sales tax.[19] The touchstone is that the compensatory scheme must be designed to promote equality of taxation of interstate and intrastate commerce.[20] The Court has been reluctant to accept general arguments that a tax compensates for a burden imposed by interstate commerce or for a differential tax on local business. In Armco Inc. v. Hardesty,[21] for example, the Court rejected the argument that a West Virginia gross receipts tax imposed on wholesale sales of goods produced out-of-state compensated for a gross receipts tax imposed at a higher rate on in-state manufacturers. The Court apparently reached this decision because the taxes were not "internally consistent"--i.e., if another state imposed a manufacturer's gross receipts tax, no provision was made to reduce or offset the West Virginia wholesale gross

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[17] Id. at 732-33.

[18] Id. at 758-60.

[19] Henneford v. Silas Mason Co., Inc., 300 U.S. 577 (1937).

[20] Maryland v. Louisiana, 451 U.S. 725, 758-760 (1981).

[21] 104 S.Ct. 2620 (1984).

receipts tax liability. As a result, out-of-state manufacturers could be subject to a heavier tax burden than local manufacturers.[22]

3. Net Income Taxes.

Net income taxes have traditionally been evaluated under a somewhat different test of discrimination than that applied to transaction taxes. In almost all net income tax cases the Court has treated the apportionment and discrimination tests to be equivalent. If the tax is fairly apportioned, it is also nondiscriminatory.[23]

In the case of a business that derives income from activities in other states, a state is constitutionally limited to taxing only that portion of its net income that is attributable to the state. To this end, all state corporate income taxes use a version of formula apportionment. Under formula apportionment a ratio of the business's in-state to out-of-state factors (most states use three: property, payroll and sales) determines the business's in-state net income. This fraction of the business's income is then subject to tax in the state. It is generally recognized that the result is simply an approximation of the income generated by or attributable to the state. But because of the difficulties (or

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[22] Id. at 2623-24. Armco is interesting in that it applied an income tax discrimination (or apportionment) standard--i.e., the requirement of "internal consistency"--to a transaction tax. See Id. at 2625 (Rehnquist dissenting). In this sense it is the converse of Westinghouse which applied the transaction tax standards of discrimination to a net income tax. See discussion in text immediately following.

[23] See, e.g., Container Corp. v. Franchise Tax Board, 103 S.Ct. 2933, 2943 (1983). In part this may simply result from taxpayers challenging net income taxes on fair apportionment, rather than discrimination, grounds. In most cases the challenged features would not seem to consistently favor local businesses. But see Moorman Mfg. Co. v. Bair, 437 U.S. 267, 283-85 (1978)(Powell, J. dissenting).

impossibilities) of precise attribution through accounting mechanisms, it is widely accepted that such approximations are the best that can be done.

Unlike net income taxes, "unapportioned" transaction taxes are constitutionally permissible if no other state could tax the same transactions.[24] Stated another way, transaction taxes may be and typically are directly apportioned to in-state or local transactions, rather than relying on approximation through formula apportionment. For example, a wholesale gross receipts tax such as that involved in Armco applies only to sales made in the state.[25]

In reviewing whether net income taxes are fairly apportioned and thus implicitly nondiscriminatory, the Supreme Court has looked to two components of fairness. In Container Corp. v. Franchise Tax Board[26] the Court labeled these as internal consistency and external consistency. Internal consistency requires that if the tax were levied by all jurisdictions, the income of an interstate business must be subject to taxation only once. External consistency requires that the formula or apportionment method must reflect a reasonable relationship to the generation of income and must not be "out of all appropriate proportions to the business transacted in that State."[27] Thus, internal consistency is

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[24] See, e.g., Western Livestock v. Bureau of Revenue, 303 U.S. 250 (1938).

[25] Throughout the remainder of this memorandum taxes limited to in-state transactions or to in-state income defined through separate accounting will be referred to as "directly apportioned," even though the more common terminology may be "unapportioned" taxes.

[26] 103 S.Ct. at 2943 (1983).

[27] Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123, 135 (1935), cited in Container Corp. v. Franchise Tax Board, 103 S.Ct. 2933, 2943 (1983).

hypothetical in nature, while external consistency looks to actual tax burdens imposed to determine if they are disproportionate.

The flexibility or looseness of these standards has permitted states to use apportionment formulas as a means of encouraging businesses to invest in the state and to provide de facto lower effective tax rates for local manufacturers. Moorman Mfg. Co. v. Bair[28] provides an example of this. In Moorman the state of Iowa used a single factor sales formula to apportion its income tax. The plaintiff was an Illinois manufacturer with substantial Iowa sales. The Court upheld the apportionment method. It was internally consistent; if all states used it, there would be no double taxation of interstate income. As to external consistency, the plaintiff did not prove any duplicative taxation of its income.[29]

The effect of the Iowa single factor formula is readily apparent. All other things being equal, it will result in lower taxes for Iowa manufacturers. For example, assume Company A has all of its manufacturing facilities and 10 percent of its sales in Iowa, while Company B has all of its manufacturing facilities in Illinois and 10 percent of its sales in Iowa. Given the same total net income, A and B will pay the same Iowa tax. This is so even though Company A has a much larger presence (its manufacturing plant and employees) in Iowa and presumably receives more government benefits and services than Company B does. Furthermore, because all other states, including Illinois, employ three factor apportionment formulas, Company B's total state tax liability would be reduced if it relocated its manufacturing operations in Iowa. Justice

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[28] 439 U.S. 885 (1978).

[29] Id. 277-81.

Powell (joined by Justice Blackmun) in his dissenting opinion contended, that as a result, the Iowa apportionment formula discriminated against interstate commerce and amounted to a tariff on goods manufactured in other states.[30] The Court's view, by contrast, was that these effects resulted from the other states' apportionment formulas, as well as Iowa's, and that under the commerce clause the Court could not mandate the use of a uniform apportionment formula by all states.[31] In other words, because the apportionment formula was internally consistent, it was fair and nondiscriminatory.

C. Discrimination and Net Income Tax Credits: Westinghouse Electric

The Westinghouse case provides a bridge between the discrimination test in transaction tax and net income tax cases. In Westinghouse the Court applied the discrimination test developed in the transaction tax cases such as Boston Stock Exchange to a net income tax credit. The predictable result was that the credit violated the commerce clause.

In Westinghouse New York state provided a credit against its corporate income tax for income of domestic international sales corporations (DISCs). DISCs, special subsidiary corporations that conduct foreign or export sales, were non-operating corporations that permitted their parent corporations to qualify under a federal tax incentive program. The DISC law permitted the parent corporation to defer a portion of its export sales income. After enactment of the federal DISC law in 1972 New York responded by requiring consolidation of the DISC and the parent.[32] This resulted in full, current taxation of DISC

[30] Id. at 283-85.

[31] Id. at 276-77.

[32] 104 S.Ct. at 1860.

income--i.e., the federal tax deferral was not recognized for purposes of the New York income tax. The special DISC credit was designed to ameliorate the effect of this denial and to provide a "positive incentive for business activity in New York * * *."[33]

The DISC credit was calculated by multiplying the parent corporation's DISC income by (1) DISC gross receipts derived from exports shipped from New York divided by total DISC gross receipts, (2) the corporation's New York business allocation percentage (i.e., the quotient derived from applying the three factor apportionment formula), (3) the corporation's New York tax rate, and (4) 0.7. This can perhaps be more easily understood expressed algebraically:

$$\text{DISC Credit} = .7ta\,\frac{d_1}{d_2}$$

where d_1 represents DISC exports from New York and d_2 is total DISC exports; a is the parent corporation's apportioned DISC income determined by applying the three factor apportionment formula; and t is the applicable New York tax rate. From this it is readily apparent that as New York DISC sales (d_1) decrease, the credit amount declines; conversely as New York DISC sales increase, the credit increases. In other words, shifting exports out of New York or otherwise disproportionately increasing non-New York exports decreases the credit, while increasing the proportion of exports from New York increases the credit. The credit, thus, provides a direct tax incentive to increase (or not to decrease) export shipping from New York.

In analyzing the tax credit, the Court made it clear that even though the New York tax fairly apportioned DISC income, "'fairly apportioned' and 'non-

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[33] Id.

discriminatory' are not synonymous terms."[34] The commerce clause could not be construed to permit a state to levy a fairly apportioned tax in the aggregate and then forgive tax through tax credits in a discriminatory fashion. The fatal flaw was that only the portion of exports shipped from New York qualified for the credit. The result was that the credit rewarded increases in New York exporting with lower taxes and penalized increased exporting from other locations with lower credits and higher taxes.[35] This, in effect, was the same circumstance as that involved in Boston Stock Exchange--higher tax rates are imposed on income derived from commerce transacted by out-of-state businesses, as compared with that derived by local businesses. This treatment, in the words of the Court, foreclosed "tax neutral decisions" and created an advantage for New York firms.[36]

Although the Court never explicitly says so, the constitutional flaw in the New York DISC credit apparently was the combination of a tax that was apportioned using formula apportionment and a credit that was directly apportioned.

First, it is clear that in offering tax credits to multistate businesses some sort of apportionment is necessary. This can be illustrated with a simple example. Assume that Company A derives 10 percent of its total net income from New York (as determined by the standard three factor formula) and 50 percent of its net income is from DISC exports (10 percent of these exports are also shipped from New York). If an unapportioned credit is provided--say a credit

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[34] Id. at 1863.

[35] Id. at 1863-65.

[36] Id. at 1867.

equal to a fraction of DISC export income--Company A would receive an unfair advantage. One-half of its income would qualify for the credit, while only one-tenth of its income would be subject to New York tax. Apportionment is necessary to ensure that the credit granted is in proportion to the share of the taxpayer's income that is taxable in the state.

Second, there are two alternative methods of apportioning the credit: formula apportionment or direct apportionment. Under formula apportionment the credit amount would be determined by multiplying the gross credit (or the factors used to determine the credit--the effect is the same) by the company's regular three factor apportionment formula. Direct apportionment, by contrast, would limit the credit to the actual amount of exports that were made from the state.

Direct apportionment traditionally has been used in transaction taxes. For example, a manufacturer's gross receipts tax is levied on the gross receipts from the manufacturer's actual sales to third parties of products that were manufactured in the state. Formula apportionment generally is used in net income taxes and similar taxes (value added taxes, for example) where the problems of intercompany pricing increase the complexity and limit the reliability of accounting techniques in directly apportioning income (i.e., to use separate accounting to determine income).[37]

The selection of one or the other of these formulas has important consequences for the effect of the credit. Direct apportionment will provide larger credits

[37] Actually some of these same problems do arise with a gross receipts tax, but they are thought to be less severe.

for businesses with more of the preferred activity in-state, while formula apportionment will provide larger credits for businesses with more in-state presence (property, payroll and sales), regardless of the jurisdiction in which it engages in the preferred activity. Thus, only direct apportionment will provide an incentive for the firm to increase its desired activity in-state.

It was this incentive effect which the Court in Westinghouse held violated the commerce clause. The New York credit would have been constitutional if the factor limiting the credit to the percentage of in-state export income had been omitted.[38] Had this been done, the tax base and the credit would have been apportioned in the same manner--i.e., using three factor apportionment. The credit would not have provided discriminatory lower effective tax rates for exporting from New York.[39]

Conversely, although this is not as clear, it appears that the credit would be constitutional if the underlying tax were directly apportioned. For example, if the New York net income tax were replaced with a directly apportioned gross receipts tax, presumably a credit could be allowed for all goods manufactured in New York and shipped to a foreign country. This sort of tax or credit would not discriminate against interstate commerce. Essentially, it would only exempt from taxation local production for sale in interstate commerce. It would not penalize increases in export production in other jurisdictions. For example, if the taxpayer moved its production to another state, liability for the gross receipts tax would cease. If it increased production in another jurisdiction, tax

[38] Id. at 1867 n. 12.

[39] In effect this is equivalent to providing a neutral lower tax rate on the qualifying income. See Seago & Schell, Tax Credits and the Commerce Clause After Westinghouse, 3 State Tax J. 101, 112 (1984).

liability under the tax and credit would not change. In short, the incentive effects for location of a facility in one state versus another would be the same as the effect of different tax rates levied by different states. Although it is somewhat more tenuous, it is also possible that if the New York tax had been apportioned using separate accounting, a credit for New York DISC sales would have been constitutional for the same reasons.

II. ANALYSIS OF THE MINNESOTA TAX CREDITS UNDER WESTINGHOUSE ELECTRIC

A. Research and Experimental Expenditures

1. Regular Research Credit

The Minnesota income tax provides a credit for increases in research and experimental expenditures over the average annual expenditures during the base period (generally the previous three years).[40] The credit is provided at a rate of 12.5 percent on the first $2 million of increased expenditures and 6.75 percent on the amount of the increase in excess of $2 million. The credit is equivalent to the federal credit for increasing research activities, except that the research must be done in Minnesota to qualify and the credit rates are lower.[41]

Although it is not crystal clear, the Minnesota research and experimental expenditure credit appears to suffer from the same defects as the New York

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[40] Minn. Stat. §290.068.

[41] I.R.C. §30; Minn. Stat. §290.068, subd. 2(b).

DISC credit in Westinghouse. If a taxpayer is weighing whether to increase its research and development activities in Minnesota or another state, the Minnesota credit will result in a lower Minnesota effective tax rate if the increases are made in Minnesota, and a relatively higher tax on Minnesota income if the research is conducted in another state.

Two examples illustrate the differential treatment of local and out-of-state firms under the Minnesota research credit.

(a) Assume that a Minnesota corporation has regularly increased research expenditures in Minnesota and that its net income increases in response to the increased investment in research. The corporation determines to move a part of its research operations out-of-state. As a result, it will have no (or lower) increases in its Minnesota research expenditures for one or more years. This action has two effects: (1) Because more of its property and payroll are located outside of Minnesota, the proportion of its income attributable to Minnesota declines. (2) Since it is not increasing its research expenditures in Minnesota, it loses its Minnesota research credit. The combined result is that its effective Minnesota corporate tax rate increases.

(b) Corporation B has a production facility and sales office in Minnesota, but conducts its research out-of-state. It determines to shift its research operation to Minnesota. Again there are two effects: (1) The proportion of its income attributable to Minnesota will increase, since it has more property and payroll in Minnesota.[42] (2) It will qualify for a research credit for the increased research expenditures in Minnesota. Because B's base year research expenditures were zero, the research credit is likely to actually reduce the absolute amount of B's Minnesota taxes compared with the prior year. Each dollar of spending (up to $2 million) will reduce its taxes by 12.5 cents; this is likely to exceed the effect of shifting a larger share of income into the state. This is a one year, transitory effect of shifting the research operation to Minnesota. However, if in subsequent tax years the corporation increases its research expenditures in Minnesota, its effective tax rate on Minnesota income will be lower than it was previous to moving the research operation, all other things being equal.

Both examples illustrate that the credit provides an incentive to conduct research in Minnesota. The greater proportion of the increase in the corporation's research that is done in Minnesota, the lower the effective tax rate on Minnesota income.[43]

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[42] Actually this may not be true or may be true to only a limited extent because Minnesota provides two apportionment formula options and the taxpayer may be able to shift from the arithmetic to the weighted formula with only a small increase in the proportion of its income attributable to Minnesota. Minn. Stat. §290.19, subd. 1.

[43] Of course, conducting research in a state with lower or no tax on corporate income may result in lower total state taxes. However, lower tax rates are not discriminatory. They are provided to all businesses regardless of where they conduct their research operations. The Supreme Court has explicitly indicated that this sort of incentive or inducement is permissible. Boston Stock Exchange v. State Tax Commission, 429 U.S. 318, 330 n. 11 (1977).

The New York DISC credit differed from the research credit in one important way. Under the New York credit increases in the proportion of total exporting conducted outside of New York were penalized by imposing a higher tax rate on New York income. This was so because the credit was computed by multiplying total DISC income by both the ratio of New York DISC exports to total DISC exports and by the taxpayer's business allocation percentage. As a result, as activity or investment outside of New York increased, the allocation percentage and the credit declined.

By contrast, the Minnesota credit applies to the absolute increases in research and development expenditures. As a result, proportionate increases elsewhere will not directly influence the Minnesota credit. However, they do represent potential forgone Minnesota credits reducing tax.[44]

Is this difference from the New York DISC credit of constitutional significance? Perhaps, but it is impossible to say with certainty. In analyzing the effects of the DISC credit the Westinghouse Court described the effect of the credit to increase New York tax as DISC exporting increased out-of-state as the "most pernicious effect of the credit[.]"[45] It may be, though, that this is simply a difference in degree, not kind. The language of the opinion implies that an incentive is unconstitutional if it imposes higher taxes on out-of-state activities than on similar in-state activities. In other words, if the incentive results in higher effective tax rates on out-of-state investment or activities, it is

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[44] The Minnesota research credit applies only to increases in research expenditures. Therefore, shifting expenditures to Minnesota will have the effect of reducing taxes for only one year. Actually this is simplistic since the credit applies to increased research expenditures necessary to keep pace with inflation.

[45] Westinghouse Electric Corp. v. Tully, 104 S.Ct. 1856, 1864 n. 9 (1984).

unconstitutional.[46] If this is so, virtually all special business credits, such as the Minnesota research credit, that provide lower effective tax rates for increased in-state investment or activity will likely be unconstitutional. At least two commentators have read Westinghouse to reach essentially that conclusion.[47]

However, if the Court does not wish to invalidate literally hundreds of state income tax credits, the distinction between a credit that rewards increases in in-state activity with lower effective tax rates and a credit that penalizes relative increases in out-of-state activity may provide a convenient basis for refusing to extend Westinghouse. The Court has indicated that state tax systems may be used to stimulate the growth of intrastate commerce and local businesses.[48] To this end, the provision of lower tax rates is clearly permissible.[49] Similarly, use of an apportionment formula which excludes the standard factors of production used in nearly all apportionment formulae (i.e., property and payroll) is also permissible.[50] However, a state tax credit that provides lower credit amounts based on the relative amounts of out-of-state activity is an unconstitutionally discriminatory incentive for in-state business

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[46] See, e.g., Id. at 1866.

[47] See Seago and Schell, Tax Credits and the Commerce Clause After Westinghouse Electric Corporation, 3 J. of State Taxation 101, 112 (1984).

[48] Boston Stock Exchange v. State Tax Commission, 429 U.S. 319, 336 (1977).

[49] Id. at 330 n. 11.

[50] Moorman Mfg. Co. v. Bair, 437 U.S. 725 (1981). It is interesting to note that Justice Blackmun, the author of the Westinghouse opinion, dissented in Moorman on the grounds that Iowa's single factor apportionment formula discriminated against interstate commerce. This may explain some of the more expansive language in Westinghouse.

activity.[51] Hence, it could be argued, tax credits for increases in absolute amounts of in-state investment or activity are nondiscriminatory stimulants of local business growth--similar in effect to the omission of local production factors from the apportionment formula.

The language of the Westinghouse opinion suggests that the distinction between credits that provide lower effective tax rates based on the actual versus the relative amount of in-state activity was not critical. The Court mentions this effect of the New York credit only twice and the opinion's examples and general language imply that all provisions that yield lower effective rates for in-state activity and thereby foreclose "tax neutral" location decisions are discriminatory.[52] The Court's analysis of what constitutes "disrimination" is

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[51] Westinghouse Electric Corp. v. Tully, 104 S.Ct. 1856 (1984).

[52] Id. at 1863 and 1865; 1863-65 fn. 9. The New York credit declined with proportionate increases in out-of-state activity because DISC income was multiplied by both the percentage of DISC sales shipped from New York and the corporation's business allocation percentage. If one assumes that DISC income increases proportionately with increases in DISC sales, deletion of the business allocation factor would make the credit essentially equivalent to a credit based on the absolute amount of DISC sales. Inclusion of the business allocation percentage, however, resulted in credit amounts declining as out-of-state factors, such as DISC sales, increased. Example 3 in footnote 9 makes this effect of the inclusion of the business allocation percentage clear.

Although the Court referred to this as the "most pernicious effect" of the credit, the first and second examples used to illustrate the effects of the credit do not capture it. These examples suggest that the incentive for in-state activity constitute discrimination as well as the effect of the credit that "penalizes" out-of-state activity. More fundamentally, the Court refers to the use of percentage of in-state DISC sales as the flaw in the New York credit. Id. at 1867, fn. 11. The Court never refers to the use of the business allocation percentage as a problem, although this was the proximate cause of the "most pernicious" effect of the credit. The Court did refer to the use of the percentage of in-state sales as duplicative apportionment, since the business allocation percentage provided adequate apportionment of the credit. Id. at 1863.

cryptic, at best, and the Court never discusses how the effects of the credit differ from the omission of production factors from apportionment formulas as upheld in Moorman Mfg. Co.[53]

2. Special Research Credit

In addition to the regular research credit, Minnesota law provides an "additional" research credit for corporations that are both domiciled in and perform research in Minnesota "for or on behalf of" a wholly owned "section 936 subsidiary." Minn. Stat. §290.068, subd. 6. The credit is provided at a rate of 12.5 percent for all research done for a qualifying 936 subsidiary. Unlike the regular credit, it is not limited to increases in research expenditures. The credit is subject to a limitation that it may not exceed the additional tax which is imposed on the unitary group of corporations as a result of including the wholly owned 936 subsidiary in the combined report for the unitary group.

Applying the Westinghouse rule, does the special research credit violate the commerce clause? Again, the answer appears to be that it does.

First, the restriction to Minnesota domiciled corporations is clearly unconstitutional. The meaning of domicile is not precisely clear. It usually is thought to refer to the state in which the corporation's principal place of business is located.[54] By so restricting the availability of the credit to

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[53]The Court never discussed what precisely made the New York DISC credit discriminatory, while the single factor apportionment formula in Moorman was not. In some ways deletion of production factors from the apportionment formula would seem to affect out-of-state businesses more adversely than a credit for in-state investment or activity. See the discussion in the appendix.

[54]See, e.g., Fischen & Van Gilder v. First Trust Joint Stock Land Bank, 210 Iowa 531, 231 N.W. 671 (1930).

businesses with their principal places of business in Minnesota, the law imposes higher effective tax rates on out-of-state businesses and lower tax rates on local businesses. This sort of blatant discrimination is not permissible.

Second, the restriction to research which is done in Minnesota is subject to the same objections discussed above with regard to the regular credit. There are two differences--(1) the special credit applies to all research expenditures, not just the annual increase over the base amount, and (2) the limitation to the increased tax resulting from unitary apportionment. Neither of these differences appears to increase the likelihood that the special research credit is constitutional.

As to providing the credit for all research, rather than just increases, this increases the incentive effect of the credit. The credit will more or less permanently lower the corporation's effective tax rate, rather than just for the first year in which additional or increased research expenditures are incurred. Thus, this makes the credit more like the DISC credit involved in Westinghouse than the regular research credit. On the other hand, the credit imposes a smaller implicit "penalty" for moving operations out of state. Under the incremental research credit, increased expenditures must continue to be made in-state to qualify for the credit. If the business determines to increase expenditures solely out-of-state, the credit will decline to zero. Conversely, under the special research credit, unless the business actually reduces in-state expenditures it will continue to qualify for the credit.

In order to assess the effect of the credit's limitation to the increased tax resulting from unitary apportionment it is necessary to understand the general manner in which corporations have used the federal tax incentives for section

936 corporations. Under federal law certain corporations conducting substantial portions of their business in Puerto Rico qualify for a tax credit under section 936 of the Internal Revenue Code. This credit eliminates the federal tax imposed on the corporation's Puerto Rican source income.

To take advantage of this forgiveness of federal tax, a company typically will transfer patents, trademarks, and proprietary processes to a Puerto Rican subsidiary. The subsidiary manufactures the product and prices it to recover the cost of both the manufacturing and the underlying research and development, and, in turn, pays royalties, license fees or other amounts to the parent corporation for the cost of the research and development. However, because the 936 credit exempts from federal taxation the income derived from Puerto Rico, the business has a natural incentive to understate the cost of the research and development in its intercorporate pricing in order to maximize its exempt Puerto Rican income.[55]

Under Minnesota law no comparable provision exempting 936 income from taxation is provided. Instead, the parent and 936 subsidiary will usually be included in a unitary group and the total income of the group will be reported in a combined report and be apportioned using the three factor formula. This will defeat the efforts to shift income to the Puerto Rican subsidiary through intercorporate transfer pricing. Absent unitary apportionment, the shifting of income to 936 subsidiaries would yield lower state tax since the 936 corporations will have disproportionate amounts of taxable income (the result of income shifting) and very low (or no) Minnesota apportionment factors.

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[55] See U.S. Treasury Dept., The Operation and Effect of the Possessions Corporation System of Taxation (1983); Treasury Proposes Less Stringent Puerto Rico Provisions, 16 Tax Notes 551 (Aug. 9, 1982).

Given this circumstance, the credit lowers the effective tax rates of Minnesota based corporations that conduct a substantial amount of research in Minnesota and transfer the resulting patents and processes to 936 subsidiaries. Corporations with 936 subsidiaries and their research operations in other states will tend to pay higher taxes by comparison. One might argue that the credit simply functions as an alternative apportionment formula--i.e., with and without combined reporting by unitary corporate groups with 936 subsidiaries. However, the option is not available to all corporations on a nondiscriminatory basis. Given the extensive use of 936 corporations and the apparent abuses under federal law, imposing the unitary apportionment method on these corporate groups probably substantially increased most of their taxes. Provision of the special research credit forgave these increases insofar as some local businesses were affected.

B. Small Business Investment Credits

1. Equity Investment Credit

Minnesota law provides a 30 percent credit for investments in the equity stock of qualified small businesses.[56] The credit applies only to the amount of the investment in excess of $25,000. The maximum allowable credit is $75,000. (The threshold is $10,000 and the maximum is $100,000 if the business's principal place of business is located in an enterprise zone.) In addition, the credit may not exceed 75 percent of the taxpayer's pre-credit liability. A qualified small business is restricted to businesses with their commercial domiciles in Minnesota.[57] If the qualified small business does business both

[56]Minn. Stat. §290.069, subd. 4.

[57]Minn. Stat. §290.069, subd. 1(f)(3).

within and without Minnesota, then the credit is apportioned based on the Minnesota proportion of the qualified small businesses' property and payroll.[58] Provision is also made for a reduction (increase) in the credit amount if the change in these factors over the succeeding two years would result in a 25 percent difference in the credit.[59]

The equity investment credit presents some novel twists in the application of the discrimination rule articulated in Westinghouse. First, lower taxes are not provided for increased activity in Minnesota by the taxpayer business, but rather for investing in an intangible (equity stock) that represents an interest in a business with operations in Minnesota. Thus, the taxpayer's liability will not vary depending upon increasing or decreasing activities in Minnesota, but rather based on the composition of its passive investment portfolio. The potential discriminatory effect is nevertheless clear: the credit is intended to alter capital flows in interstate commerce by inducing more equity investment capital to flow from Minnesota taxpayers to Minnesota small businesses. The credit will have no effect on investors who are not already Minnesota taxpayers, unlike the Westinghouse DISC credit or the Minnesota research credits. All of these credits operated as inducements to out-of-state firms to locate or expand in Minnesota. This difference is unlikely to affect the credit's constitutionality. The credit will still induce Minnesota taxpayers to alter the composition of their investment portfolios in favor of the stocks of qualifying small Minnesota businesses, as contrasted with out-of-state firms.

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[58] Minn. Stat. §290.069, subd. 4b.

[59] Id.

The second interesting feature of the credit is the provision of the two factor apportionment formula. In Westinghouse, the Court indicated that had New York only used the taxpayer's business allocation percentage in reducing the credit, it would have been constitutional.[60] Does the use of an apportionment formula save the constitutionality of the credit? Does it matter that a two factor formula is used, when net income is apportioned using a three factor formula?[61]

Unlike the DISC credit in Westinghouse, the equity investment credit's apportionment formula is not dependent upon the factors of the taxpayer but rather the business in which the investment is made. This distinction is of critical importance.

The function of the apportionment formula, in theory and as described by the Court in Westinghouse, is to limit the credit to the share of the taxpayer's income that is attributable to the state.[62] To illustrate, assume a business derives 2 percent of its net income from New York (as determined under the three factor apportionment formula), and further assume that 30 percent of its total income would qualify for DISC deferral. In other words, the business does a significant amount of exporting out of states other than New York. If no apportionment formula were used, the DISC credit would provide a tax reduction disproportionate to the taxpayer's New York income. The apportionment formula assures that only the portion of the taxpayer's DISC income that is taxable by New York will qualify for the credit.

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[60]Westinghouse Electric Corp. v. Tully, 104 S.Ct. 1856, 1863, 1867 n. 12 (1984).

[61]Compare Minn. Stat. §290.19, subd. 1.

[62]104 S.Ct. at 1863.

Because the equity investment credit is not apportioned on the basis of the taxpayer's factors, it does not ensure the credit is provided in proportion to the taxpayer's in-state income. Rather, because the apportionment is based on the factors of the company invested in, it ensures that for an investment in a multistate business, the credit will be provided only in proportion to that business's operations in Minnesota. Thus, the apportionment formula serves to magnify or focus the incentive for investing in a Minnesota operation, increasing rather than lessening the discrimination against interstate commerce. This fact is reinforced by the use of a two factor, rather than the usual three factor formula. By excluding the sales factor, the value of the credit is increased for businesses with most of their facilities in Minnesota, but with some or all of their sales outside of the state. The two factor apportionment formula increases the discriminatory effect of the credit.

Given the above, it appears that the equity investment credit as currently structured violates the commerce clause. Also it should be noted that the restriction of qualifying small businesses to those with their commercial domicile in Minnesota is unconstitutional for the same reasons discussed above relative to the similar restriction in the special research credit.

2. Technology Transfer Credit

A second special investment credit is allowed to corporate taxpayers who transfer "technology" to qualified small businesses. This credit is provided at a rate of 30 percent and is limited to a maximum credit of $300,000.[63] The

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[63]Minn. Stat. §290.069, subd. 2.

definition of qualified small business is the same as applied to the equity investment credit and the same apportionment mechanism is used.[64]

Insofar as considerations of discrimination against interstate commerce are concerned, this credit is in all respects the same as the equity investment credit. The analysis as outlined above would apply to it as well, suggesting that the credit violates the commerce clause.

C. Pollution Control Credits

The Minnesota income tax provides two separate tax credits for purchases of pollution control equipment. Both credits become effective for tax year 1985.[65] Essentially the same credits were in effect prior to tax year 1983, but were repealed by the Legislature for the 1983 and 1984 tax years.[66]

The regular pollution control equipment credit is provided for 5 percent of the net cost of equipment used primarily to abate or control pollutants.[67] The credit is subject to a maximum limit of $75,000 with a four year carryover. The law does not specifically restrict its application to equipment installed in Minnesota; however, the credit only applies to equipment that is "installed or operated in accordance with a permit or order issued by the [Minnesota Pollution Control] agency[.]"[68] This restricts the credit to pollution control equipment that is installed in Minnesota.

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[64] Minn. Stat. §290.069, subd. 1, 4b.

[65] Minn. Stat. §290.06, subd. 17, 18.

[66] Minn. Laws 1983, chap. 342, art 1 §44.

[67] Minn. Stat. §290.06, subd. 17.

[68] Minn. Stat. §290.06, subd. 17(a)(1).

A more generous 10 percent credit (the "feedlot pollution control credit") is provided for the cost of pollution control equipment installed in connection with a feedlot operation.[69] This includes lagoons, concrete storage pits, slurry handling devices and so forth. The devices must be approved by the pollution control agency to qualify and must be installed in Minnesota. However, there is no requirement that the equipment be installed in compliance with a Minnesota pollution control agency order.

Because the pollution control credits are restricted to investment in pollution control equipment in Minnesota, they are subject to the same sorts of claims of discrimination outlined above under the research credit. A business that locates more of its business facilities requiring installation of pollution control equipment to comply with federal law will have lower Minnesota effective tax rates compared with a business that locates more of such facilities in other states. On the surface, this would seem to create a discriminatory incentive for businesses that require pollution control equipment to locate in Minnesota.

However, there may be an adequate justification for this sort of preferential treatment of local businesses. It is widely accepted that Minnesota imposes significantly more stringent pollution control regulations upon its businesses than the federal government and nearly all other states do. If this is so, the pollution control credits may be justified on the ground that they merely compensate for this additional regulation and do not result in lower effective tax rates for Minnesota businesses who purchase pollution control equipment. Second, the credits may be viewed as a mechanism for the state to purchase

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[69] Minn. Stat. §290.06, subd. 18.

cleaner air and water for its citizens, similar to the state's direct expenditures of budget funds for environmental purposes. The combined use of regulations and compensating tax credits may be the most efficient mechanism for accomplishing this. Both of these arguments are dependent upon a compensatory tax type of argument and further would depend upon proof that the state does in fact impose more stringent pollution control regulations and that the cost of complying with them does not exceed the credit.

In Maryland v. Louisiana,[70] Louisiana made a similar argument that it was imposing higher taxes on gas pipelines to compensate for the environmental damage that was done. However, the tax was not designed to accomplish that goal and the Court did not directly address the argument.[71] The discriminatory features of the Louisiana first use tax simply did not further the environmental compensation goals.[72]

In contrast to a tax on pollution, the Minnesota scheme provides for the state's general fund to pay part of the cost of reducing emissions or effluents. Both approaches, if properly structured, appear to be neutral as between local and interstate commerce and therefore should be constitutional. More specifically, so long as the pollution control credits provide rough compensation for more stringent Minnesota pollution regulations, the credits have a fair probability of being upheld. Under those circumstances the combination of more stringent

[70] 451 U.S. 725, 732 (1981).

[71] Id. at 724-25.

[72] See Pierre, The Constitutionality of State Environmental Taxes, 58 Tulane L. Rev. 169 (1983); Edwards, Zehner, and Moore, Constitutional and Policy Implications of Louisiana's Proposed Environmental Energy Tax: Political Expediency or Effective Regulation, 58 Tulane L. Rev. 215 (1983).

regulation and compensating credits does not provide any incentive to locate in Minnesota and does not favor local producers over out-of-state producers. That is not so, though, if the credits make it cheaper to comply with federal pollution control regulations that a business would face in any state.

D. Resource Recovery Credit

In 1984 the Legislature enacted a 10 percent credit for equipment used to process solid and hazardous waste at resource recovery facilities.[73] The definitions of the types of equipment that qualify for the credit are determined by reference to the waste management law.[74]

Neither the language of the tax credit itself, nor the references in the waste management law, restrict the qualifying equipment to that installed at locations within Minnesota. One might reasonably hypothesize that the Legislature intended to restrict the credit to facilities that were either located in Minnesota or primarily processed Minnesota generated waste. However, it is difficult to derive such a limitation from the language of the statute. Resource recovery processing equipment acquired and used at any location by the taxpayer should qualify. As a result, there is no discrimination against interstate commerce or out-of-state owners or operators of resource recovery facilities.

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[73] Minn. Laws 1984, chap. 644 §52, codified at Minn. Stat. §290.06, subd. 16. The credit is provided for the "use" of resource recovery equipment, not its acquisition or placement in service. It is not clear, but presumably the credit is only to be provided on a one-time basis for any given piece of equipment. The statutory language is susceptible to an interpretation that the credit is allowed annually.

[74] Minn. Stat. §115A.03.

If the Legislature were to impose such a limit--either requiring the facility to be located in Minnesota or to process some proportion of Minnesota waste--it is an interesting question whether the limitations would be constitutional. In many ways the state would be using a tax expenditure device in a way very similar to the direct spending program Maryland used in the Alexandria Scrap case.[75] In that case the Court upheld a higher bounty paid to in-state recyclers of junker cars on the theory that the state was acting as a market participant rather than a regulator.[76] Since the resource recovery technology is likely to be more expensive than depositing the waste in a landfill, one could also make a series of arguments based on compensating for the external environmental benefits of recycling and processing waste at resource recovery facilities. These arguments would follow those outlined above under the pollution control credits section and would suggest that if a compensatory link could be established, the credit would be constitutional.

E. Conservation Tillage Farm Equipment Credit

In 1984 the Legislature enacted a 10 percent credit for conservation tillage planters.[77] These planters are defined as planters or attachments used in a variety of types of conservation tillage systems.[78] The law does not impose a maximum dollar limitation on the amount of the credit.

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[75] Hughes v. Alexandria Scrap Corp., 426 U.S. 794 (1976).

[76] The "market participant" rule is discussed under Legislative Alternatives. See below section III, part D.

[76] Minn. Laws 1984, chap. 502, art. 2 §6, codified at Minn. Stat. §290.06, subd. 19.

Minn. Stat. §290.06, subd. 19(d)(1).

The terms of the credit do not restrict it to qualifying equipment used on farms in Minnesota. A multistate corporation which is subject to tax in Minnesota and operates a farm in another state, say North Dakota, Iowa or California, could claim the full credit for all qualifying equipment regardless of where it is used. Thus, the credit does not discriminate in favor of local businesses or against interstate commerce or out-of-state producers. As a result, it would be constitutional under the Westinghouse rule.

If the Legislature were to restrict the credit to equipment used to till Minnesota farm land, constitutional problems would be presented since it would discriminate in favor of local producers. One could make arguments similar to those outlined under the pollution control credits. However, the credit could not be justified as compensation for more stringent land conservation regulations, unless the state actually imposes them. Given that farm income is assigned to the state using separate accounting rather than formula apportionment, such a restriction perhaps could be upheld on the theory outlined above.[79] Under this sort of analysis, the credit would be the same as an exemption from a transaction tax that is imposed only on local producers. Given the small amount of farming that is done by multistate businesses, a restriction to Minnesota used equipment may be unnecessary in any case.

[79] Minn. Stat. §290.17, subd. 2(2); See the discussion in section I, part C.

III. LEGISLATIVE ALTERNATIVES

A. Introduction

If the analysis and conclusions outlined in parts I and II are correct, the Westinghouse case suggests that the Minnesota research and small business investment credits unconstitutionally discriminate against interstate commerce. If this is so, the Legislature may wish to consider changes to preserve the credit programs or to eliminate them if the constitutional restrictions prevent them from meeting the original legislative intent underlying the programs.

The Legislature has four general alternatives:

(1) Eliminate the discriminatory features of the credits;

(2) Retain the status quo, but make changes that reduce the probability of a loss in revenue if the credits are successfully challenged in court;

(3) Convert the credits to direct spending programs, rather than tax expenditure programs; and

(4) Repeal the credits and reduce the tax rates by an equivalent amount.

Each of the alternatives will be briefly analyzed in turn.

B. Eliminate the Discriminatory Features of the Credits

The Westinghouse Court fairly clearly indicated that the New York DISC credit would have been constitutional if it had not been limited to the share of the corporation's total DISC exports shipped from New York.[80] The Minnesota credits could similarly be made constitutional by deleting the restrictions to activity or investment in Minnesota.

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[80] Westinghouse Electric Corp. v. Tully, 104 S.Ct. 1856, 1867 n. 12 (1984).

Under this approach the research credit would be provided as a percentage of the corporation's increased research expenditures without regard to whether the research was conducted in Minnesota. The credit (or the research qualifying for the credit) would then be reduced or apportioned using the corporation's regular business allocation percentage (determined by applying the three factor formula used in apportioning net income to the state). Similarly, the equity investment credit and the technology transfer credit would be provided for investments in qualifying businesses, regardless of whether they were domiciled in or did business in Minnesota. These credits, when claimed by multistate corporations, would also be apportioned or reduced using the taxpayer's business allocation percentage.

These changes would make the credits constitutional. However, they would significantly change the economic effects of the credits with the result that they may no longer meet the goals and intent of the Legislature. The incentive provided by the research credit would simply be to conduct more research and development. The credit would no longer encourage the business to conduct that research in Minnesota. If the Legislature's goal is to use the tax structure to encourage expansion of the research and development activities in Minnesota, the modified credit would only imperfectly satisfy this goal.

The effect on the equity investment and technology transfer credit would be similar. If the goal was to stimulate investment in Minnesota businesses and to encourage the growth of technology based new companies in Minnesota, the modified credits would not be targeted specifically to that purpose. It does seem likely though that Minnesota taxpayers will invest a disproportionate share of their funds in local companies even without the legal restriction.

Out-of-state companies likely will be unaware of the availability of the incentives and thus will not apply for the necessary certification from the Commissioner of Energy and Economic Development in order to qualify under the credit.[81]

The special research credit for research done for 936 subsidiary corporations could be replaced by permitting all unitary corporate groups to delete 936 subsidiaries from the requirement of combined reporting. This would likely result in a not insignificant drop in corporate income tax revenues. Alternatively, the restriction to research done in Minnesota by a Minnesota domiciled corporation could be eliminated and the credit apportioned using the regular business allocation formula. The former approach is consistent with a view of legislative intent that the credit was designed to eliminate the effect of combined reporting on unitary groups with 936 subsidiaries. This seems likely given the peculiar maximum restriction on the credit.[82] The latter approach is consistent with the view that the Legislature wanted to encourage research to be done for production of products in Puerto Rico. This seems unlikely.

Permitting 936 corporations to opt out of unitary apportionment would, however, be inconsistent with the purpose behind the adoption of combined reporting. The generally recognized purpose of formula apportionment and combined

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[81] Minn. Stat. §290.069, subd. 1(f)(6).

[82] Minn. Stat. §290.069, subd. 6 (credit may not exceed additional tax paid as a result of combined reporting).

reporting is to eliminate the distortions in an individual corporation's income that result from nonmarket, intercompany transactions. The available evidence indicates that this is precisely the circumstance with 936 corporations; indeed the evidence seems to indicate that the distortions are not inadvertent, but rather are intentional manipulations to take advantage of the federal tax advantages under section 936.[83]

C. Retain the Status Quo

A second option would be to retain the credits in their current form. The Supreme Court when faced with cases involving other credits may be willing to retreat from the strong language in Westinghouse, distinguishing credits with somewhat different factual circumstances. For example, the New York DISC credit could be distinguished on the basis that it was calculated in a manner that caused the credit to decline with relative increases in out-of-state activity. If total DISC exports increase and the New York DISC exports do not, the credit is reduced. The Minnesota credits generally use the absolute amount of activity or investment (research, pollution control equipment, etc.) in Minnesota. The New York method provided a stronger incentive to locate (or retain) facilities in-state. The use of absolute amounts in calculating the credits prevents activity outside the state from directly affecting the credit amounts. The plain language of the Westinghouse opinion implies that the Court will not be persuaded by this distinction. However, in the past the Supreme Court has occasionally retreated from recently articulated new constitutional rules affecting state taxation.[84]

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[83] See the discussion above in section II, part A.2.

[84] The classic instance of this is Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938) and Freeman v. Hewitt, 329 U.S. 248 (1946).

An important factor in determining whether this is a reasonable strategy is the risk to the state of lawsuits challenging the constitutionality of the credits. There are several factors to consider. What remedies are available to taxpayers who challenge the constitutionality of credits? How likely is it that taxpayers will challenge the credits? What are the administrative costs to the state and taxpayers of such suits?

Whether the invalidation of the credits will result in a revenue loss, depends in part upon the remedy granted the challenging taxpayer. There are essentially two alternative remedies. The Court could invalidate the entire credit. This would provide no advantage to the taxpayer and would actually result in increased revenues for the state. Alternatively, the Court could invalidate the discriminatory portion of the credit and uphold the remainder. For example, with regard to the research credit, the application of the credit to only research conducted in Minnesota could be invalidated and the credit applied to the entire increase in qualifying research conducted by the corporation. This approach could significantly reduce state revenues. Finally, although there is no direct precedent for it in tax cases, the court could fashion a damages remedy.

One technique commonly used by the courts in deciding which remedy is appropriate is to determine whether the discriminatory provision is "severable" from the remainder of the credit. Under this approach if the discriminatory feature is severable, the remainder of the credit is permitted to stand and the taxpayer can compute its taxes under the credit without the restrictions. On the other hand, if the discriminatory feature is an integral part of the law, then the entire credit is invalidated. In determining severability questions, the intent of the Legislature is critical. One formulation of the test would be whether the Legislature would have enacted the credit without the discriminatory feature.

Minnesota law provides a general presumption that the provisions are severable.

> If any provision of a law is found to be unconstitutional and void, the remaining provisions of the law shall remain valid, unless the court finds the valid provisions of the law are so essentially and inseparably connected with and dependent upon, the void provisions that the court cannot presume the legislature would have enacted the remaining valid provisions without the void one * * *.[85]

Several factors suggest that insofar as the business credits discussed in this memorandum are involved, the discriminatory features of the credits are "inseparably connected with and dependent upon" the remainder of the credits. First, there is a general recognition that the primary purpose of the credits is to stimulate in-state investment and business development. If one accepts this, extension of general credits to stimulate expanded research or investment in small business nationally by the Legislature seems unlikely, although not impossible. The Minnesota Supreme Court reached essentially that result in the case striking down the reduced excise tax rate for alcohol gasoline motor fuel blends where the alcohol was produced from Minnesota agricultural products.[86] In judging the legislative intent, the Court was particularly persuaded by the fact that most of the benefit (85 percent) in the gasohol case would have gone to out-of-state producers.[87]

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[85] Minn. Stat. §645.02.

[86] Archer Daniel Midlands Co. v. State, 315 N.W.2d 597 (Minn. 1982).

[87] The court probably was wrong, however. In the succeeding legislative session the lower rate was reenacted for alcohol-gasoline without regard to its origin. 1983 Minn. Laws, Chap. 17 §7, codified at Minn. Stat. §296.02, subd. 7.

Second, other than the restriction to Minnesota activity or investment, the credits are unapportioned relative to either Minnesota income or activity. Thus, a corporation which derives a relatively small proportion of its income from Minnesota and which conducts a large amount of the desired activity in total would receive a credit disproportionate to its Minnesota income. This argues that the Legislature would not have enacted the credits without the restrictions to Minnesota activity.

In any case, the Legislature could amend the credits to make it clear that the restrictions to Minnesota activities were nonseverable from the remainder of the credit. This sort of restriction could be applied to subsequent tax years, but presumably could not be applied retroactively to those tax years which have already passed.

If the discriminatory features of the credits are not severable from the remainder of the credit, taxpayers would seem to have little incentive to file suit challenging the constitutionality of the credits. If the taxpayer's suit is successful, the entire credit is lost and the taxpayer's liability will increase.[88]

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[88] It has been suggested that this would be the ultimate resolution of Westinghouse. See Seago and Schell, Tax Credits and the Commerce Clause After Westinghouse Electric Corporation, 3 J. of State Taxation 101, 111-12 (1984). This did not actually occur in Westinghouse. On remand, the New York Court of Appeals treated the case as simply a question of severability. Westinghouse Electric Corp. v. Tully, 63 N.Y.2d 191, 481 N.Y.S.2d 55 (1984). The New York law contained no general severability clause, but the court concluded that the discriminatory features of the tax were severable and that the remainder of the credit was valid. Id. at ---, 481 N.Y.S.2d at 58-59. The Court rejected arguments by the taxpayer that the entire scheme for taxing DISC income was invalid and by the Tax Commission that the entire credit was invalid. Neither of these two results would have satisfied the Legislature's dual goals of (1) preventing a significant revenue loss in the taxation of DISCs and (2) providing some incentive for expanded manufacturing of exports and exporting in New York. Id. It should be noted that insofar as questions of severability are concerned the legislative history of the New York DISC credit is significantly different from that of the Minnesota business credits.

The plaintiff's only hope is that the Legislature will respond to the successful lawsuit by enacting a nondiscriminatory credit or by reducing the tax rates. In short, if the discriminatory features are nonseverable, the plaintiff's remedy is to compel the state to collect higher taxes from local businesses, in the hope that the Legislature will respond by enacting a nondiscriminatory tax reduction.

Taxpayers may argue that the combination of a discriminatory tax credit and a nonseverability clause violates due process protection by effectively denying them a judicial remedy for the constitutional violations. Equitable remedies such as an injunction--particularly a temporary injunction--of allowance of the discriminatory credit could provide some relief by requiring the state to collect higher taxes from its local businesses during the pendency of the litigation. However, the federal tax injunction act generally prevents taxpayers from obtaining injunctions against the collection of a state tax.[89] State law similarly does not provide for injunction of the collection of an illegal tax where a general law remedy is provided.[90] The standard remedy is to file a suit for a refund or to appeal from an order of the commissioner imposing a higher amount.[91] In the case of a nonseverable, discriminatory feature of a tax credit, the allowance of a refund obviously provides the taxpayers with no remedy during the tax years while the suit is in litigation.[92] However, granting equitable relief against allowance of the credit could result in chaos for administration of the income tax.

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[89] 13 U.S.C. §1341.

[90] Fichtner v. Schiller, 271 Minn. 263, 135 N.W.2d 877 (1965).

[91] See Minn. Stat. §§271.06, 290.531.

[92] In fact, the taxpayer could be insisting on paying a higher tax, if the taxpayer would qualify for some tax reduction under the credit.

Given this circumstance, the taxpayer may argue that for the state to enact a discriminatory credit and a nonseverability clause denies taxpayers an adequate remedy for the constitutional violation and thereby fails to provide due process. The taxpayer could argue that invalidation of only the discriminatory features of the credits is constitutionally compelled. Alternatively, if equitable relief is inappropriate because of the likely disruption of the tax administration system, perhaps a constitutional damage remedy should be fashioned.[93] The likely measure of damages--the loss in net income suffered as a result of the credit--would be difficult to prove or measure and probably would be small.

There is no apparent direct precedent for this sort of constitutional damage remedy in tax cases. However, these sorts of issues may be addressed on remand of the recently decided case holding unconstitutional preferential state alcohol excise tax exemptions for locally produced liquor.[94] One would expect that the taxpayers' chances of prevailing would be enhanced if it was apparent that the Legislature specifically enacted the nonseverability clause in response to a Supreme Court decision that strongly suggested that the credits were unconstitutional.[95]

D. Repeal the Credits and Replace with Direct Spending Programs

As a third alternative, the Legislature could repeal the credits and replace them with a direct spending program. For example, open end entitlement programs of grants to qualifying businesses could very nearly replicate the economic

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[93] See, e.g., Bivens v. Six Unknown Named Agents of the Federal Bureau of Narcotics, 403 U.S. 388 (1971).

[94] Bacchus Imports, Ltd. v. Diaz, 104 S.Ct. 3049, 3056 (1984).

[95] See Ely, Democracy and Distrust 136-145 (1980); --, Legislative and Administrative Motivation in Constitutional Law, 79 Yale L. J. 1205 (1970).

effect of the tax credits. Under this approach the state would continue to collect the corporate tax, but without the preferential credits or other reduction features. The additional revenue generated by the repeal of the credits would provide the necessary state funds to finance the direct spending programs. A qualifying business would fill out a grant application, rather than claiming a credit on its tax return, and would receive a check from the state, rather than paying a reduced amount of taxes. Other than these formal differences, a direct spending program could be designed to have roughly the same economic effect as the discriminatory credit. In short, a tax expenditure program would be converted to an equivalent direct spending program.

A direct spending program by its nature is likely to have some inevitable differences from a tax credit. One probable difference is that a direct spending program would generally provide grants to all qualifying businesses, not just those with Minnesota tax liability equal to or greater than the credit amount.[96] In other words, the grants would function like refundable tax credits.[97] Second, unlike the New York DISC credits, a grant program presumably would not provide for apportionment of the grants relative to the qualifying business's allocation percentage for corporate tax purposes.[98] These

[96] A direct spending, grant program could provide, of course, that one of the necessary qualifications is that the business have state tax liability equal to or greater than the applied for grant. This would be an unusual provision for a direct spending program and probably would increase the probability that the constitutional rules applicable to discriminatory tax credits would be applied to the direct spending programs. See the discussion below.

[97] None of the Minnesota tax credits is refundable. The enterprise zone law provides for refundable credits, though. Minn. Stat. §273.1314(9)(h).

[98] None of the Minnesota credits is apportioned using the three factor formula.

two differences from the New York DISC credit would tend, however, to enhance the type of discrimination that the Court found impermissible in Westinghouse.

From a public policy perspective, converting the tax credits to direct spending programs has both advantages and disadvantages. It would increase the costs of administering the programs since taxpayers would need to fill out and file separate sets of forms and the state would need to process the additional forms.

The state would probably need to make greater efforts to publicize the availability and terms of the programs, since the tax system (forms, preparers, etc.) would no longer operate as natural publicists and explainers of the programs. On the other hand, direct spending programs generally have greater visibility in the legislative process and the programs are likely to be subject to more rigorous scrutiny of whether they are fulfilling their purposes. The use of direct spending would permit public examination of the businesses that benefit from the programs since the income tax secrecy laws would no longer apply. This may permit more accurate assessment of the effects of the programs. Finally, conversion to direct spending programs would require the tax credits' cost to appear in the state budget totals. This would increase the accuracy of the budget totals in reflecting the extent to which the state is redirecting private resources through taxing and spending.

If the economic effects of a direct government spending program are essentially equivalent to those of an unconstitutionally discriminatory tax credit, is the direct spending program also unconstitutional? Perhaps not. Direct spending programs have generally been evaluated under a separate set of commerce clause standards that differ from those applicable to taxes and regulation. The Supreme Court has not examined or discussed the relationship between direct spending programs and tax expenditure programs such as the New York DISC credit. Thus, the line that is drawn between application of the two sets of rules is necessarily imprecise and unclear.

In a line of three recent cases the Court has held that a state may discriminate in favor of local businesses in direct spending programs, if it does so as a "market participant" rather than through regulation or taxation.[99] However, none of the these market participation cases has done more than suggest the outlines of the distinctions between market participation and market regulation or taxation. Nor has the Court discussed the relationship between direct spending and tax expenditure programs and the distinction between market participation and regulation or taxation.[100]

Alexandria Scrap involved a Maryland subsidy program to encourage the recycling of junk cars titled in Maryland ("hulks" in the terminology of the law).[101] Under the law the state paid the processor a bounty for each hulk

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[99] Hughes v. Alexandria Scrap Corp., 426 U.S. 794 (1976); Reeves, Inc. v. Stake, 447 U.S. 429 (1980); White v. Massachusetts, 103 S.Ct. 1042 (1983).

[100] One exception to this is Justice Stevens concurring opinion in Alexandria Scrap: "Nor, in my judgment, does that Clause [the commerce clause] inhibit a State's power to experiment with different methods of encouraging local industry. Whether the encouragement takes the form of a cash subsidy, a tax credit, or special privilege intended to attract investment capital, it should not be characterized as a 'burden' on commerce." Hughes v. Alexandria Scrap Corp., 426 U.S. 794, 816 (1976). Westinghouse has proven this expansive view of the rule of Alexandria Scrap to be wrong. Westinghouse Electric Corp. v. Tully, 104 S.Ct. 1856 (1984).

[101] Hughes v. Alexandria Scrap, 426 U.S. 794 (1976).

that was recycled. Originally the law treated in-state and out-of-state processors alike. However, in 1974 the Maryland legislature imposed more stringent documentation requirements on out-of-state processors. As a result, the flow of hulks to out-of-state processors was significantly reduced.[102] Despite this showing of a burdening of interstate commerce, the Court held that the differential treatment did not violate the commerce clause because the state acted as a market participant, rather than a regulator.[103]

Why the Maryland action constituted market participation, rather than regulation, was not made clear by the Court. The Court appeared to be influenced by the fact that the activity looked more like purchasing of goods, rather than regulation.[104] However, as the dissent points out, Maryland was not acting as a final purchaser of goods.[105] Rather, it was using the subsidy payments to stimulate the desired private action, the recycling of junk cars. The same results could easily be accomplished through regulation.

In Reeves, Inc. v. Stake,[106] the state of South Dakota owned and operated a cement plant. The plant regularly sold its output to out-of-state purchasers. However, when a cement shortage developed in 1978, the state allocated priority to in-state purchasers. Plaintiff, a Wyoming contractor, was unable to obtain cement. The Court held that the operation of the plant "unquestionably fits

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[102] Id. at 803-04.

[103] Id. at 806.

[104] Id. at 808-09.

[105] Id. at 824-29 (Brennan, J. dissenting).

[106] 447 U.S. 429 (1980).

the 'market participant' label more comfortably than a State acting to subsidize local scrap processors."[107] In reaching this conclusion the Court apparently was persuaded by the fact that the operation of a state cement plant was more proprietary in nature and thus did not involve as great an opportunity for interfering with interstate commerce. The Court notes that the commentator's criticisms leveled at the Alexandria Scrap rule would not generally apply to proprietary activities.[108] However, the Court does not further articulate why this is so or whether the appropriate distinction is between governmental and proprietary activities.[109]

The most recent case, White v. Massachusetts,[110] involved a challenge to an executive order of the mayor of the city of Boston. The order required contractors with the city to employ one-half city residents on construction projects funded by the city. The Court held that in constructing public buildings and other works the city was acting as a market participant and was not therefore subject to the restraints of the commerce clause.[111] As with the other cases, White provided only cursory discussion of why the activity was

[107] Id. at 440.
[108] Id. at 440 fn. 14.

[109] The dissent written by Justice Powell, the author of the Alexandria Scrap opinion, views this distinction as cutting the opposite way. The provision of traditional governmental services would be immunized, but those that attempt to insulate private economic forces from the interstate market would not. Id. at 447, fn. 1. It is hard to understand how the Maryland law in Alexandria Scrap could survive this sort of test.

[110] 103 S.Ct. 1042 (1983).

[111] Id. at 1044, fn. 7.

market participation rather than regulation. The Court in a footnote noted that the employees of the contractors were, in "an informal sense," city employees and thus the activity was well within the definition of market participation.[112]

However, the Court did take some care in distinguishing Hicklin v. Orbeck[113] from the circumstances in White.[114] Hicklin involved an Alaska law which required state resident preference in hiring by virtually anyone benefiting from an oil lease to which the state was a party. Hicklin was decided under the privileges and immunity clause, not the commerce clause. Nevertheless the Court noted that the city of Boston's executive order did not "attempt to force virtually all businesses that benefit in some way from the economic ripple effect" of the city contracts to favor residents in their hiring.[115] Thus, the implication is that spending programs that discriminate against out-of-state businesses (or laborers) in a more pervasive manner are likely to be considered regulation or taxation that violates the commerce clause.[116] This may suggest that provisions favoring local businesses are permissible when they are simply adjuncts of other state programs and thus by their nature limited in scope. A

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[112] Id.

[113] 437 U.S. 518 (1978).

[114] White v. Massachusetts, 103 S.Ct. 1042, 1046 (1983).

[115] White v. Massachusetts, 103 S.Ct. 1042, 1046 (1983), quoting Hicklin v. Orbeck, 437 U.S. 518, 531 (1978).

[116] The dissent in Reeves made essentially this distinction--i.e., that it depended upon the magnitude of the effect on interstate commerce. Reeves, Inc. v. Stake, 447 U.S. 429, 452 (1980)(South Dakota law cut off interstate trade, while Maryland law did not). The majority rejected this distinction between the two cases. Id. at 435 n. 7.

more pervasive tax credit or spending program that is simply and baldly designed to attract new business investment or retain existing businesses in the state would not be "market participation."[117]

Perhaps, direct spending programs that are limited in scope and directed at specific state policy purposes for providing recognized public goods, such as cleaning up scrap automobiles or constructing public works, would qualify. Programs that are "open-ended" and simply aimed at promoting local business development or protecting local firms from interstate competition would not qualify. However, the recent case of Garcia v. San Antonio Metropolitan Transit Authority[118] indicates, in a different context, the Court's unwillingness to rely upon a standard that depends upon characterizing state programs as "traditional" or "governmental" versus "proprietary" or similar standards.

In any event, no coherent and consistent view of what constitutes "market participation" as contrasted with "market regulation or taxation" has been articulated by the Court. Given this, would conversion of the Minnesota tax credits to direct spending programs increase the probability that they would survive a commerce clause challenge? Several factors suggest that the answer to this question is a qualified yes. The probabilities increase, but it remains improbable that the resulting direct spending programs, directed toward the same ends as the tax credits, would be constitutional.

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[117] This formulation probably is not a fair reflection of the Court's decisions since it was essentially the view of the dissent in Reeves. 447 U.S. 429, 449-51 (1980).

[118] 53 L.W. 4135, 4137-4140 (1985).

It seems clear from the Westinghouse opinion that the Court does not view tax expenditure programs as the type of programs that warrant consideration under the Alexandria Scrap line of cases. In part this may stem from the failure of the litigants to make the appropriate arguments or from the general tendency to view state tax cases as sui generis as a matter of commerce clause doctrine.[119] In part, it may also result from the general reluctance to consider the reduction in tax base provided through tax credits and deductions as government spending programs. In any case, the conversion of the credits to direct spending programs would seem to overcome these difficulties.

Notwithstanding this, the prospect for favorable treatment of the converted tax credit programs under the market participant line of cases seems dim. Unlike the programs upheld under the market participant doctrine, the tax credit programs have the primary and sole objective of favoring local firms to stimulate their expansion at the expense of out-of-state firms.[120] As a result, the tax credit programs contain none of the natural limits on their pervasiveness that more traditional types of government spending programs do. Tax rates can simply be raised and more expansive or generous credits provided to local businesses.[121]

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[119] See Tribe, American Constitutional Law 344 (1978)

[120] The exceptions to this are the pollution control and resource recovery credits which are designed to further environmental goals and in this sense are similar in a way to the underlying program in Alexandria Scrap.

[121] Of course, there is a practical limit on how high tax rates may be increased to revenue yields constant in response to expanded tax preferences.

Although little discussed by the Court, a fundamental theme that probably underlies the market participant doctrine is that local taxpayers are entitled to limit the benefits of government spending to local residents.[122] If local taxpayers have paid the taxes to finance the government spending, one intuitively thinks that they should be able to restrict the benefits of the spending to local firms. This sort of rationale underlies the privilege and immunities clause doctrine which permits differential fees for nonresident fishing licenses, state college tuition, and so forth.[123]

This rationale begins to break down in the context of tax preferences under the corporate income tax. Local firms are not the only payors of corporate income tax. Rather out-of-state firms with sufficient nexus in the state will pay a portion of the tax as determined by their proportionate presence in the state determined under the apportionment formula. Thus, if revenue is raised with corporate taxes that are paid by out-of-state and in-state firms alike and the benefits of the government spending are limited to in-state firms, this intuitive sense of equity disappears.

Of course, it is impossible to determine which tax generated the revenue to finance the spending, since all general revenues are deposited and commingled in the general fund. Furthermore, taxes paid only by resident individuals (individual income and sales taxes) comprise the overwhelming majority (over 71 percent for fiscal year 1985) of general revenues. However, the conversion of

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[122] See Reeves, Inc. v. Stake, 447 U.S. 429, 442, 452 n. 3 (1980).

[123] See, e.g., Baldwin v. Montana Fish and Game Commission, 436 U.S. 371 (1978).

the tax credits to direct spending programs may appear to be a more or less transparent effort to raise the funds through the corporate income tax and to convert an illegal credit into a valid direct spending program with an equivalent economic impact. It is worth noting that, although in a somewhat different context, both Alexandria Scrap and Reeves rejected similar arguments based on the history of the programs revealing the discriminatory intent of the Legislature.[124]

Finally, one would hope that the Supreme Court would not treat direct spending and tax expenditure programs with essentially equivalent effects differently for commerce clause purposes. Such a result would run counter to the Court's desire to consider the economic substances of taxes, rather than legal formalism.[125]

E. Repeal the Credits

A final alternative is to simply repeal the tax credits and to enact an offsetting reduction in the tax rate. This has the advantage of being simple and straightforward. However, to the extent the Legislature desires to use the tax system to stimulate investment in local businesses and in-state activity such as the conduct of additional research and development in Minnesota it would not meet those goals.

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[124] Hughes v. Alexandria Scrap Corp., 426 U.S. 794, 809 (1976); Reeves, Inc. v. Stake, 447 U.S. 429, 440-41 (1980).

[125] See Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

APPENDIX

The Court in Westinghouse failed to articulate a clear standard for determining when a tax credit or other feature of an otherwise fairly apportioned net income tax discriminates against interstate commerce. Westinghouse Electric Corp. v. Tully, 104 S.Ct. 1856 (1984). Furthermore, the Court never attempted to reconcile the result and reasoning in Westinghouse with Moorman. Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978). The discrimination standard formulated by the dissent in Moorman seems remarkably like the reasoning of Westinghouse. Compare Id. at 283-286 with Westinghouse Electric Corp. v. Tully, 104 S.Ct. at 1863-65, fn. 9. Given this circumstance, it would seem incumbent upon the Court to resolve the differences. Instead, it simply ignored the issue, failing to discuss or even cite Moorman.

The Court in Westinghouse stated or restated several different verbal formulations of a standard for determining discrimination:

(1) The New York tax scheme provided not only a "positive incentive for increased business activity in New York * * * [but also] penalize[d] increases in" out-of-state activity. Westinghouse Electric Corp. v. Tully, 104 S.Ct. 1856, 1865 (1984).

(2) The commerce clause prohibits taxes that impose greater burdens on economic activity taking place outside the state than on similar activities within the state. Id. at 1866.

(3) A tax is discriminatory if it "forecloses tax neutral decisions" and creates an advantage for firms operating in-state. Id. at 1867.

(4) The New York tax resulted in effective tax rates decreasing as in-state activity and income increased. Id. at 1864 fn. 9.

(5) The most "pernicious effect" of the New York tax was to lower the incentive it awards for in-state DISC activity as the DISC increases its out-of-state activity." Id.

It is not clear how the application of any of these standards of discrimination will yield different results in the Westinghouse and Moorman cases. A single factor formula such as that employed by Iowa in Moorman appears to have the economic effects outlined in (1) through (5). The difference is, perhaps, that the effects are caused by a fundamental feature of the tax--i.e., the determination of how much income is attributable to the state. Selection of the apportionment formula effectively determines the amount of the in-state income. As a result, for example, effective rates (as in (4)) would not decline as a result of increased in-state activity, since they are computed as a fraction of in-state income. However, this is a distinction of form, rather than economic substance.

Given the Court's failure to discuss Moorman, perhaps using apportionment formulae for stimulating in-state business or creating advantages for local businesses is permissible. For example, one approach would simply be to omit the favored production factors from the in-state factors in calculating the allocation percentage. This would seem to be somewhat like Moorman, but would have more than a tinge of the transparent favoritism for local businesses that violates Westinghouse. Alternatively, the taxpayer could be allowed a choice of optional apportionment formulas as many states (including Minnesota) now do.

The following series of examples illustrates the varying effects of three alternative methods of stimulating in-state investment and activity: (1) a 100 percent sales apportionment formula as in Moorman, (2) a 10 percent credit for in-state increases in in-state property and payrolls, and (3) omitting increases in property and payrolls from calculation of the in-state apportionment factors. Separate examples are provided for firms with all, proportionate, and virtually no in-state production factors. The comparisons illustrate that the 100 percent sales apportionment has the same (and, in fact, more powerful) in-state incentive effect as the credit. In fact, it has the peculiar effect cited by the Westinghouse Court in footnote 9 as the most pernicious effect of the peculiar New York DISC credit, while a credit (without double apportionment as in the New York DISC credit) does not. See 100 percent sales apportionment in example #2 which shows that the effective rate of tax increases under 100 percent sales apportionment when the investment is made out-of-state.*

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*Adoption of 100 percent sales weighting as an in-state investment incentive is not a politically viable option for most states that have a significant number of branch operations of large national companies, unless it is done on an optional basis. (100 percent sales weighting would impose high effective rates of taxation on a branch operation unless the branch is proportionate in size to the in-state sales of the national company.) If it is done on an optional basis, it does not have the effect of directly "penalizing" out-of-state activity, except to the extent that it results in higher nominal tax rates being imposed.

EXAMPLE #1 -- PROPORTIONATE

	Year #1			Year #2					
				In-State Investment			Out-of-State Investment		
FACTORS:	Minn.	Total	Pct.	Minn.	Total	Pct.	Minn.	Total	Pct.
Sales	$1,000	$10,000	.10	$1,100	$11,000	.10	$1,100	$11,000	.10
Property	100	1,000	.10	200	1,100	.1818	100	1,100	.0909
Payroll	100	1,000	.10	200	1,100	.1818	100	1,100	.0909
Arithmetic Average			.10			.1545			.0939
Total Income		$2,000			$2,200			$2,200	
In-state Income*		200			340			206	
(1) Tax (100% sales apportionment)		24			26			26	
Effective Tax Rate**		12%			7.8%			12.6%	
(2) Tax (arithmetic and credit+)		200			21			25	
Effective Tax Rate**		12%			6.1%			12%	
(3) Tax (arithmetic and omit the increase in property and payroll from in-state factors)		200			25			25	
Effective Tax Rate**		12%			7.4%			12%	

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* Determined using arithmetic average apportionment.

** Tax/In-state income.

\+ 10 percent of increase in property and payroll.

EXAMPLE #2 -- ALL IN-STATE PRODUCTION

	Year #1			Year #2: In-State Investment			Year #2: Out-of-State Investment		
FACTORS:	Minn.	Total	Pct.	Minn.	Total	Pct.	Minn.	Total	Pct.
Sales	$1,000	$10,000	.10	$1,100	$11,000	.10	$1,100	$11,000	.10
Property	1,000	1,000	1.00	1,100	1,100	1.00	1,000	1,100	.9090
Payroll	1,000	1,000	1.00	1,100	1,100	1.00	1,000	1,100	.9090
Arithmetic Average			.70			.70			.6394
Total Income		$2,000			$2,200			$2,200	
In-state Income[*]		1,400			1,540			1,406	
(1) Tax (100% sales apportionment)		24			26			26	
Effective Tax Rate[**]		1.7%			1.7%			1.8%	
(2) Tax (arithmetic and credit[+])		168			165			169	
Effective Tax Rate[**]		12%			10.7%			12%	
(3) Tax (arithmetic and omit the increase in property and payroll from in-state factors)		168			169			169	
Effective Rate[**]		12%			11%			12%	

[*] Determined using arithmetic average apportionment.

[**] Tax/In-state income.

[+] 10 percent of increase in property and payroll.

EXAMPLE #3 -- ALL OUT-OF-STATE PRODUCTION

	Year #1			Year #2					
				In-State Investment			Out-of-State Investment		
FACTORS:	Minn.	Total	Pct.	Minn.	Total	Pct.	Minn.	Total	Pct.
Sales	$1,000	$10,000	.10	$1,100	$11,000	.10	$1,100	$11,000	.10
Property	10	1,000	.01	110	1,100	.10	10	1,100	.0091
Payroll	10	1,000	.01	110	1,100	.10	10	1,100	.0091
Arithmetic Average			.04			.10			.0394

	Year #1	In-State Investment	Out-of-State Investment
Total Income	$2,000	$2,200	$2,200
In-state Income*	80	220	87
(1) Tax (100% sales apportionment)	24	26	26
Effective Tax Rate**	30%	12%	30%
(2) Tax (arithmetic and credit+)	10	6	10
Effective Tax Rate**	12%	2.7%	12%
(3) Tax (arithmetic and omit the increase in property and payroll for in-state factors)	10	10	10
Effective Tax Rate**	12%	4.5%	12%

* Determined using arithmetic average apportionment.
** Tax/In-state income.
\+ 10 percent of increase in property and payroll.