

MANUFACTURING DEVELOPMENT COMMISSION

August 22, 2008

Are exemptions from local property taxes for the machinery and tools of companies that relocate to Virginia permissible?

Tax incentives, whether income tax, sales tax or property tax related, have come under recent scrutiny by the courts. When viewing these incentives they must withstand scrutiny by courts interpreting both the state constitutions and the *United States Constitution*.

The following analysis looks at the tests that have been applied by the courts to challenges under the *United States Constitution* and the *Constitution of Virginia*. While certain trends can be identified and certain general conclusions can be reached, the courts are the ultimate arbiters of what is and what is not permissible.

Taxation is one of the core powers of any government. Constitutions are designed to limit the exercise of government powers such as taxation. The analysis that follows focuses on a government's ability to discriminate through its tax system. But when a government does the same thing as its citizens, such as spend money, the constitutional limitations on discrimination do not apply. Therefore, the constitutional questions that surround tax exemptions and tax incentives are not applicable to "grant" programs.

United States Constitutional Implications

When a state exercises government power to provide for the health and welfare of its citizens, but distributes benefits unequally, the distinctions it makes are subject to scrutiny under Equal Protection Clause of the Fourteenth Amendment of the *United States Constitution*. Generally, a law will survive scrutiny under the equal protection clause if the distinction rationally furthers a legitimate state purpose. A reading of Supreme Court cases show that distinctions that favor long term residents over newcomers are suspect, and the majority have been held unconstitutional.

Tax incentives offered by states to companies that invest or expand business operations in the state are also subject to scrutiny under the Commerce Clause, Article 1, Section 8 of the *United States Constitution*. In general, a challenged exemption will fail Commerce Clause scrutiny if it discriminates on its face or if the provision discriminates against interstate commerce in practice by providing direct commercial advantage to local business. The fact that the state has a rational basis for claiming that the discrimination advances a legitimate local purpose is not a defense unless the state also proves that the purpose cannot be adequately served by reasonable nondiscriminatory alternatives.

In 2004, the Sixth Circuit Court of Appeals addressed the constitutionality of an Ohio investment tax credit for new manufacturing machinery and equipment that was installed in the state, and an Ohio law allowing Ohio municipalities to offer property tax abatements to businesses investing in economically depressed areas. The Court ruled that the investment tax credit violated the Commerce Clause because it coerced business to further invest in Ohio at the expense of other states by reducing a pre-existing tax liability. However, the Court also ruled that the property tax exemption did not violate the Commerce Clause because it directly related to the use of the exempted property and, unlike the tax credit, did not reduce an already owed tax liability, but only allowed the taxpayer to escape taxation on the new investment. The Court noted, however, that requirements for exemptions based who the business serves or employs would most likely make the exemption unconstitutional. The Supreme Court of the United States held that the plaintiff had no standing to challenge the investment tax credit and reversed the Sixth Court of Appeals ruling that it was unconstitutional.

It would be hard to show that a distinction that favored newcomers over long term residents would not violate the Equal Protection Clause and the Commerce Clause. However, distinctions based on when equipment is put in service or when investments are made could be seen to rationally further a legitimate purpose.

Virginia Constitutional Implications

Article X, §§ 1 and 2 of the *Constitution of Virginia* provide that all property, unless specifically exempted within the provisions of the *Constitution*, must be taxed, and must be taxed at a uniform rate among classes. Article X, § 6 of the Constitution of Virginia lists all property that may be exempted from taxation. The *Constitution* does not currently allow the General Assembly to exempt machinery and tools.

Alternatives

An alternative to amending the *Constitution of Virginia* to exempt machinery and tools is for the General Assembly to classify it as intangible property, which localities are prohibited from taxing. Although Virginia taxed the capital of many businesses for years, since 1984 the tax rate on intangible personal property has been zero, but the tax and its definitions has not been repealed. Currently, the definition of intangible personal property includes inventory and personal property of businesses, but excludes machinery and tools, motor vehicles, and delivery equipment, used in manufacturing, mining, water well drilling, radio or television broadcasting, dairy, dry cleaning or laundry businesses, cable television businesses, and commercial fishing businesses.

Another alternative is for the General Assembly to provide a separate class for the property it seeks to exempt. This would give the locality the option to tax the property at a lower rate.

Both of these alternatives would be subject to review under the Equal Protection Clause or the Commerce Clause of the *United States Constitution*. Under an analysis of current case law, a machinery and tools tax exemption based on new investment in a locality would most likely be constitutional, while a machinery and tools tax exemption only for new businesses would be less likely to be constitutional. However, the courts ultimately determine if an exemption is valid, and, so far, there have been no cases that deal directly with this issue.