Coates' Canons Blog: Valid Cash Incentive or Illegal Tax Rebate?

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One **news outlet reported** that in exchange for constructing a data center in North Carolina, Apple Inc. will be reimbursed by North Carolina local governments for "50 percent of tax revenue on real estate property — buildings and land — and 85 percent of tax revenue on business property — computers and other equipment — for the next 10 years." How do we determine whether this is an improper tax exemption or a valid incentive? I'm afraid there's no "app for that."

It is not uncommon for local governments to calculate cash incentives for a business as a percentage of property taxes paid. Cash incentives awarded in this way tend to be prospective in nature; in other words, a business is eligible to receive a cash incentive each year for some number of years, provided it pays its taxes and meets other criteria during each eligible year. There are several practical reasons for using this format, primarily to ensure that the business pays property taxes first and that the incentives awarded never exceed a set percentage of the tax revenue it generates.

One school of thought, however, suggests that local governments should avoid calculating the incentive as a percentage of tax revenue received, lest the incentive be viewed as an illegal tax rebate prohibited by **G.S. 105-380**. Furthermore, the North Carolina Constitution establishes in Section 2 of **Article V** that only the General Assembly may classify or exempt property for taxation. Taken together, the concern is that poorly designed incentives could be construed as an improper attempt by a local government to classify or exempt property for taxation. How substantial is this risk?

The question can be avoided entirely if incentives are awarded without direct or indirect reference to property taxes paid. This can be accomplished, for example, by offering a fixed cash incentive per year or by calculating the incentive with reference to some other factor such as a fee certain for each job created. However, if the incentive is not capped by the amount of property taxes paid, then there is a separate risk that the local government will pay out more than it intended as a percentage of the tax revenues it receives.

In an attempt to balance these concerns, local governments often calculate incentives on the basis of a factor which serves as a close (sometimes identical) substitute for the tax revenue actually received. Examples of such proxy factors include total capital investment made or taxable value of capital investment made. Although these proxies are employed to distance an incentive from the tax classification problem, they could be susceptible to a "form over substance" argument in that they typically have the same effect as calculating incentives by tax revenues directly. An additional risk, and a counter-argument to the form over substance problem, is that these proxy factors occasionally do a poor job of measuring expected tax revenue. They fail to track actual property tax revenues when capital investments are counted for purposes of calculating an incentive but are later exempted from tax (e.g., the business applies for a tax exemption for its pollution control equipment). This problem can be corrected through careful drafting of incentive agreements, but as those agreements get better at accurately tying incentives to tax revenues, the "form over substance" argument resurfaces.

Case law does not clear up the issue either, but it is worth mentioning that the North Carolina Supreme Court let stand a court of appeals ruling regarding Dell Inc.'s incentives in ***Blinson v. State***, 186 N.C. App. 328 (2007). The plaintiffs' brief pointed out that the local government incentives package "reflects the projected property tax to be paid by Dell," and "Dell will essentially not pay property taxes for the next fifteen years by virtue of the cash grants or reimbursements from the local governments." Plaintiffs raised the tax classification issue, but that claim was dismissed for lack of standing. The issue was therefore never resolved, except to highlight the practical difficulties of mounting a legal attack on that basis.

Perhaps this suggests taking a different approach to the problem. A focus on what incentives should not do—namely classifying or exempting property from taxation—may not be as important as what incentives should strive to be. As discussed below, an argument can be made that properly designed incentives do not classify property for taxation. An examination of two guiding principles, taken from case law and the statutes, suggests a positive focus on how to build a cash incentive in such a way to make it difficult to characterize it as an illegal classification of property—even when the incentive is tied to tax revenues generated.

1. *Ensure incentives serve diverse public purposes.* The seminal incentives case, *Maready v. City of Winston-Salem*, 342 N.C. 708 (1996), explains that incentives serve a public purpose when offered for the purpose of “enlarging the tax base.” This lessens the concern about tying an incentive to tax revenues generated by the business. After all, to ensure the tax base increases, it is necessary to measure incentives against tax revenues—perhaps even tying the two together directly. But the *Maready* court did not sanction the single-minded pursuit of tax revenues; rather, it said that public purposes are served by seeking diverse benefits such as “providing displaced workers with continuing employment opportunities, attracting better paying and more highly skilled jobs, enlarging the tax base, and diversifying the economy.” To put it simply, a cash incentive should be offered to obtain more than mere capital investment—it should be contingent on job creation, wage standards, or other factors unconnected to property tax revenue. Once an incentive is meaningfully contingent on factors other than taxable property—even if it is capped or even calculated as a percentage of tax revenue generated—it becomes difficult to characterize the incentive as a property tax classification or exemption. And keep in mind that the rationale driving the N.C. Supreme Court’s decision in *Maready* was attracting substantial new jobs and tax base that “might otherwise be lost to other states.”

2. *Ensure incentives are governed by an agreement which comports with statutory requirements.* **G.S. 158-7.1**(h) requires incentive agreements to contain provisions to recapture “sums appropriated or expended” in the event that the business (1) creates “fewer jobs than specified in the agreement,” (2) makes “a lower capital investment than specified,” and (3) fails to “maintain operations at a specified level for a period of time specified in the agreement.” I’ll save for later a discussion of how that requirement is applied in the context of cash incentives paid over a course of years, but for now it suffices to say that these provisions serve as excellent guidelines for local governments to follow in all incentive agreements. Employment- and wage-based contingencies are unrelated to property classifications. Likewise, requiring a business to maintain operations at a certain level captures much more public benefit—e.g., local supply purchases, business presence and activity, employee and management leadership in the community, employee spending—than is represented by the taxable value of the business’ property. To the extent that incentive payments are conditioned on these other factors—even if the incentive is capped or calculated as a percentage of taxes paid—one must strain to argue that the incentive is an unconstitutional classification of real or personal property.

Let’s conclude with an example and a question. Say that an incentive is designed such that a business will receive 10% of its property taxes paid in a given year for every employee hired at a certain wage, up to a maximum of ten employees (at which point the incentive will be equal to 100% of taxes paid). Is this an illegal property tax classification or is it a valid employment incentive? Because it is conditioned on hiring a certain number of employees at a certain wage standard, I would argue that this incentive isn’t an unconstitutional classification of real or personal property. Sure, it explicitly measures the incentive as a percentage of taxes paid, but it is based on much more than the value of taxable property owned by the business; it also measures the number of employees making a certain wage (and by extension, the business’ continued operation at a certain level). Do you think a court would agree?

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