Montana Legislative Services Division

Legal Services Office

PO BOX 201706
Helena, MT 59620-1706
(406) 444-3064
FAX (406) 444-3036

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Senator Keith Bales
HC 39 Box 33
Otter, Montana 59062

Dear Senator Bales:

I am writing in response to your request for an opinion concerning the constitutionality of certain Montana statutes and certain types of tax incentives. Statutes are presumed to be constitutional, and the Supreme Court will avoid an unconstitutional interpretation if possible. A party challenging the constitutionality of a statute has the burden of proving it unconstitutional beyond a reasonable doubt, and any doubt will be resolved in favor of the statute. Montanans for Responsible Use of School Trust v. State ex rel. Board of Land Commissioners, 1999 MT 263, 296 Mont. 402, 989 P.2d 800 (1999), following Steer, Inc. v. Department of Revenue, 245 Mont. 470, 803 P.2d 601 (1990).

Your first question concerns section 15-24-3001, MCA. That section provides for a 10-year property tax exemption for an electrical generation facility and related delivery facilities constructed in Montana after May 5, 2001, and before January 1, 2006. In order to be exempt from property taxation, the owner and operator of the electrical generation facility and related delivery facilities is required to offer contracts to sell 50% of that facility's net generating output at a cost-based rate, which includes a rate of return not to exceed 12%, to customers for a 20-year period from the date of the facility's completion. The property tax exemption is limited to a 5-year period for generation facilities powered by oil or gas turbines. To the extent that 50% of the net generating output of the facility is not contracted for delivery to consumers for a contract term extending 5 years to 20 years from the completion of the facility, as determined by the owner, surplus capacity must be offered on a declining contract term basis for the remainder of the contract period at a cost-based rate that includes a rate of return not to exceed 12%. Surplus capacity that is not contracted for in this fashion may be sold at market rates. If an owner or operator of property exempt from taxation signs a contract to sell power as required in section 15-24-3001(1), MCA, and then fails to perform the contract during the applicable period, the property tax exemption is void and the property is subject to a rollback tax as provided in section 15-24-3002, MCA.

There appear to be two possibilities for constitutional challenge to the type of tax incentive contained in section 15-24-3001, MCA. The first area of attack involves the Commerce Clause, contained in Article I, section 8, of the United States Constitution. The Commerce Clause delegates a positive power to Congress to regulate commerce between the states. The Commerce Clause has also been interpreted to contain a negative or "dormant" implication that preempts the power of the states over interstate commerce even in the absence of a positive enactment by Congress.

In Pacific Power & Light Co. v. Department of Revenue, 237 Mont. 77, 773 P.2d 1176 (1989), certain privately owned utility companies entered into an agreement with a federal agency to use the agency's power lines located in Montana to transmit electricity to out-of-state users. The companies argued that a beneficial use tax imposed on them was preempted by several federal laws, including 15 U.S.C. 391 that provides that a tax is discriminatory if it results in a greater tax burden on electricity that is generated and transmitted in interstate commerce than on electricity that is generated and transmitted in intrastate commerce. The Supreme Court held that the tax did not violate the federal law because it was applied at the same rate on both interstate and intrastate users. In reaching its conclusion the Montana Supreme Court applied the test contained in Complete Auto Transit Inc. v. Brady, 430 U.S. at 274 (1977). That test requires, upon examination of the practical effect of the tax, that the tax be applied to an activity having a substantial nexus with the taxing state, be fairly apportioned, not discriminate against interstate commerce, and be fairly related to the services provided by the taxing state. The Montana tax passed muster under this test.

In Commonwealth Edison Co. v. Montana, 453 U.S. 609 (1981), Montana coal producers and out-of-state utility customers brought suit challenging the constitutionality of Montana's severance tax on coal mined in the state. The United States Supreme Court held that Montana may constitutionally raise general revenue by imposing a severance tax on coal mined in the state. The entire value of the coal before transportation originates in the state, and mining the coal depletes the resource base and wealth of the state, thereby diminishing a future source of taxes and economic activity. The severance tax was found not to discriminate against interstate commerce under the four-part test set forth in Complete Auto Transit. The Court held that when, as here, a general revenue tax does not discriminate against interstate commerce and is apportioned to activities occurring within the state, the state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, and to benefits which it has conferred by fact of being an orderly civilized society.

In Boston Stock Exchange v. State Tax Commission, 429 U.S. 318 (1977), New York enacted a tax that provided sellers of stock a reduction in a stock transfer tax if the stock sale was made through New York brokers. The tax reduction was designed to encourage in-state business activity. The United States Supreme Court found that the tax reduction offended the nondiscrimination principle inherent in the Commerce Clause. Under the statute, the seller's decision of where to sell the stock would no longer be made solely on the basis of nontax criteria. The Court concluded that New York was using its power to tax an in-state operation as a means of requiring other business operations to be performed in New York. However, the Court noted that its decision did not prevent states from structuring their tax systems to encourage the growth and development of intrastate commerce and industry.

In Bacchus Imports, Ltd. v. Dias, 468 U.S. 263 (1984), the United States Supreme Court struck down a Hawaii statute that exempted certain locally produced alcoholic beverages from its wholesale liquor excise tax. The purpose of the tax was to aid Hawaiian industry. However, the motivation of the Legislature was irrelevant to the Commerce Clause inquiry as to whether the tax discriminated against out-of-state products.

An income tax credit was invalidated in Westinghouse Electric Corporation v. Tully, 466 U.S. 388 (1984). In 1971, Congress granted preferred status to any entity that qualified as a Domestic International Sales Corporation (DISC). Under federal law, DISCs were not taxable on their income and their shareholders were taxable only on a portion of the income. New York enacted legislation that provided that a DISC's income was combined with the income of the parent company for state tax purposes. New York also granted a partial credit for the parent company against the tax attributable to the DISC. The credit was determined by applying 70% of the parent company's tax rate to the parent company's share of the DISC income as apportioned to New York by the parent company's business allocation percentage. The credit was then adjusted to reflect the ratio of the DISC's receipts from New York export shipments to its receipts from all export shipments. The Court determined that the only type of credit that would pass constitutional muster was a credit apportioned to New York on the same basis that the DISC income was apportioned to New York. By tying the credit to New York activity the tax rate on DISC income varied directly with the extent of the taxpayer's New York DISC-related activity. The credit also decreased when the taxpayer increased its DISC-related activity elsewhere. The credit created an advantage for firms operating in New York by placing a burden on commerce in the other states and therefore violated the Commerce Clause. The effective New York tax rate on DISC income could not vary based upon the amount of the taxpayer's activity in New York and survive muster.

A tax credit designed to encourage production of ethanol in Ohio was construed in New Energy Company of Indiana v. Limbach, 486 U.S. 269 (1988). Ohio provided a credit against its motor fuel tax for each gallon of ethanol sold as a component of gasohol, but only if the ethanol was produced in Ohio or in a state that granted similar tax benefits to Ohio-produced ethanol. The United States Supreme Court held that the tax credit explicitly deprived certain products of generally available beneficial tax treatment because they were produced in certain other states and therefore the credit was facially discriminatory. Ohio claimed that the same result it was seeking could have been achieved by way of a cash subsidy to the ethanol producer. The Court noted that the Commerce Clause does not prohibit all state action favoring local over out-of-state interests, but only that action that arises out of the state's regulation of interstate commerce. While the direct subsidization of domestic industry does not normally violate the Commerce Clause, discriminatory taxation of out-of-state manufacturers does violate the Commerce Clause.

These cases, which include tax rate reductions, tax exemptions, and tax credits can lead to the conclusion that all tax incentives are suspect under Commerce Clause analysis. By their very nature, tax incentives are designed to avoid tax-neutral decisionmaking whereby business decisions are made solely on the basis of criteria other than taxes. In spite of these cases, virtually all states continue to offer tax incentives that are designed to create or stimulate business activity in the taxing state. It is possible that a tax incentive could pass muster if the incentive favors in-state over out-of-state activity and if there is no direct tie to differential tax liability. For example, with regard to the property tax exemption contained in section 15-24-

3001, MCA, there is no additional tax liability that can be shown to attach to out-of-state activity. The condition precedent for the tax exemption, the offer to sell 50% of that facility's net generating output at a cost-based rate, which includes a rate of return not to exceed 12%, to customers for a 20-year period from the date of the facility's completion, is not limited to Montana consumers. Because I am unable to tie this tax exemption to any out-of-state activity, it should pass Commerce Clause muster. In Boston Stock Exchange, the Court noted that states can structure their tax systems to encourage the growth and development of intrastate commerce and industry. 429 U.S. at 336. What the Commerce Clause prohibits a state from doing is using its tax structure to require business to be conducted in that state in order to gain favorable tax treatment vis-a-vis business conducted in another state. In other words, the effective tax rate may not be tied to whether the activity occurred in state or out of state. The Commerce Clause prohibits discrimination against interstate commerce and discrimination against out-of-state taxpayers.

Because section 15-24-3001, MCA, involves electrical generation, some additional analysis is necessary. In General Motors Corporation v. Tracy, 519 U.S. 278 (1997), the United States Supreme Court was asked to address Ohio's taxation of natural gas purchases. Ohio imposed its general sales and use taxes on natural gas purchases from all sellers, whether in state or out of state, except regulated public utilities that met Ohio's statutory definition of a "natural gas company." The question was whether this difference in tax treatment between sales of gas by domestic utilities subject to regulation and sales of gas by other entities violated the Commerce Clause or Equal Protection Clause of the United States Constitution. The Court upheld the taxation scheme. The Court noted that as a response to the monopolistic shakeout that brought an end to the era of unbridled competition among gas utilities, regulation of natural gas for the principal benefit of householders and other consumers of relatively small quantities is the rule in every state. The continuing importance of the states' interest in protecting the captive market from the effects of competition for the largest consumers was underscored by the common sense of the Court's traditional recognition of the need to accommodate state health and safety regulations in applying dormant Commerce Clause principles. State regulation of natural gas sales to consumers served important interests in health and safety in fairly obvious ways, in that requirements of dependable supply and extended credit ensure that individual buyers of gas for domestic purposes were not frozen out of their houses in the cold months. Ohio's regulatory response to the needs of the local natural gas market resulted in a noncompetitive bundled gas product that distinguishes its regulated sellers from independent marketers to the point that the enterprises should not be considered "similarly situated" for purposes of a claim of facial discrimination under the Commerce Clause. General Motors Corporation's argument that Ohio discriminated between regulated local gas utilities and unregulated marketers therefore failed.

In spite of the holding in General Motors, a similar result would not be reached with regard to electricity. When Congress enacted the Tax Reform Act of 1976, it included a provision relating to state taxes on electricity. Section 15 U.S.C. 391 provides that a state may not impose or assess a tax on or with respect to the generation or transmission of electricity that discriminates against out-of-state manufacturers, producers, wholesalers, retailers, or consumers of that electricity. For purposes of that section, a tax is considered discriminatory if it results, either directly or indirectly, in a greater tax burden on electricity which is generated and transmitted in interstate commerce than on electricity which is generated and transmitted in intrastate commerce. In Arizona Public Service Commission v. Snead, 441 U.S. 141 (1979), the United States Supreme Court struck down a New Mexico energy tax on the privilege of generating electricity within the state. The tax applied to all utility companies generating electricity within New Mexico and could be credited against the New Mexico gross receipts tax liability for electricity sold at retail within New Mexico. However, where the electricity was transmitted to other states for sale and consumption, there was no gross receipts tax liability against which to offset energy tax liability. The New Mexico energy tax was invalid by reason of the federal statute under the Supremacy Clause, contained in Article VI of the United States Constitution. Because the tax itself, through operation of the tax-credit provisions, indirectly but necessarily discriminated against electricity sold outside New Mexico, it violated the federal statute. The federal statute did not exceed the permissible bounds of congressional action under the Commerce Clause, because Congress had a rational basis for finding that a tax such as New Mexico's interfered with interstate commerce and selected a reasonable method to eliminate that interference. This case does not appear to invalidate section 15-24-3001, MCA, because the requirement to offer contracts to sell 50% of that facility's net generating output at a cost-based rate, which includes a rate of return not to exceed 12%, to customers for a 20-year period from the date of the facility's completion in order to obtain the tax exemption is not restricted to Montana consumers. Therefore, the tax exemption does not appear to violate the federal statute.

The second area of presumed constitutional attack on section 15-24-3001, MCA, would be under the Equal Protection Clauses contained in section 1 of the 14th Amendment to the United States Constitution and in Article II, section 4, of the Montana Constitution. The Equal Protection Clauses essentially require that similarly situated individuals and entities be treated in the same manner. In the area of taxation, the Legislature is required to have a rational basis for its action. Montana Stockgrowers Association v. State, 238 Mont. 113, 777 P.2d 285 (1989), followed in GBN, Inc. v. Department of Revenue, 249 Mont. 261, 815 P.2d 595 (1991).

In the area of taxation, the United States Supreme Court has indicated that even under the rational basis test, its review is especially deferential. See Nordlinger v. Hahn, 505 U.S. 1 (1992), in which the United States Supreme Court held that California's acquisition-value assessment scheme did not violate the Equal Protection Clause of the 14th Amendment to the United States Constitution. The Court held that unless a state-imposed classification warrants some form of heightened review because it jeopardizes exercise of a fundamental right or categorizes on the basis of an inherently suspect characteristic, the Equal Protection Clause requires only that the classification rationally further a legitimate state interest. In permitting longer-term owners to pay less in taxes than newer owners of comparable property, California's assessment scheme rationally furthers at least two legitimate state interests. First, because California had a legitimate interest in local neighborhood preservation, continuity, and stability, it legitimately could decide to structure its tax system to discourage rapid turnover in ownership of homes and businesses. Second, California legitimately could conclude that a new owner, at the point of purchasing property, does not have the same reliance interest warranting protection against higher taxes as does an existing owner, who is already saddled with a purchase and does not have the option of deciding not to buy the home if taxes become prohibitively high.

In Allied Stores of Ohio v. Bowers, 358 U.S. 522 (1959), the Supreme Court was asked to determine whether an Ohio statute that exempted from ad valorem taxation merchandise or agricultural products belonging to a nonresident if held in a storage warehouse for storage only denied to the appellant, a resident of the state, the equal protection of the laws guaranteed by the Fourteenth Amendment of the Constitution. The Court held that is was entirely settled that a statute that encourages the location within the state of needed and useful industries by exempting them, though not also others, from its taxes is not arbitrary and does not violate the Equal Protection Clause of the Fourteenth Amendment.

The Legislature has classified property for purposes of taxation. Statutes that provided for the classification of property for purposes of taxation do not infringe upon the guarantee of the equal protection of the laws. Hilger v. Moore, 56 Mont. 146, 182 P. 477 (1919). The Legislature may properly even go to the extent of placing identical articles in the hands of different owners in different classes, because different uses result in different productivity. A classification will be upheld if it has a reasonable relation to some permitted end of governmental action. Wheir v. Dye, 105 Mont. 347, 73 P.2d 209 (1937). However, when a classification results in discrimination, it is an unconstitutional exercise of the legislative function to classify property for taxation. Victor Chemical Works v. Silver Bow County, 130 Mont. 308, 301 P.2d 730 (1956). In Roosevelt v. Department of Revenue, 1999 MT 30, 293 Mont. 240, 975 P.2d 295 (1999), the Montana Supreme Court held that creating a class of property owners whose taxes are assessed on a basis greater than the market values of their property, while other property owners are assessed on the actual or less than the actual market values of their property, causes the property owners in the first class to pay a disproportionate share of state taxes, in violation of the equal protection guarantee in Article II, section 4, of the Montana Constitution.

However, in addressing an equal protection challenge to section 15-24-3001, MCA, a court would also be required to consider Article VIII, section 5, of the Montana Constitution providing that the Legislature may exempt any class of property from taxation. There is only one pertinent case interpreting this provision. In Montana Stockgrowers Association, the Montana Supreme Court reversed a lower court decision that held that taxing livestock while exempting business inventories was unconstitutional in that the law denied certain individuals equal protection under the federal and state constitutions. The Supreme Court ruled that a middle tier scrutiny was not required; rather the proper test was a rational basis test to determine if there was a basis for treating inventory and livestock differently. Under the rational basis test, it was clear that the Legislature had acted rationally in applying different classifications, and historically the two properties had been treated differently. The reason for the dearth of case law on exemptions is that the cases interpreting the 1889 Montana Constitution are not relevant to the 1972 Montana Constitution. Article XII, section 2, of the 1889 Montana Constitution made it mandatory that all property listed in that section be exempt from taxation. A successful equal protection challenge to a tax exemption could possibly be based upon an allegation that the Legislature had not exempted a "class" of property from taxation as authorized by Article VIII, section 5, of the

Montana Constitution, but only certain property within a class. That appears to be the case with the exemption contained in section 15-24-3001, MCA, under which an electrical generation facility and related delivery facilities constructed in Montana before May 5, 2001, and after January 1, 2006, would be taxed even if the contractual conditions for the sale of electricity were met. However, because a tax exemption is involved, it cannot be asserted with certainty that section 15-24-3001, MCA, would be found to violate Montana's Equal Protection Clause.

The second statute that you have asked me to address is section 15-35-103, MCA. You have specifically asked me to address the provision in section 15-35-103(1)(b), MCA. That section provides for a two-thirds reduction in the rate of coal severance tax for coal that is used for the production of electricity within the state in an electrical generation facility that was constructed after December 31, 2001, and before January 1, 2008. In addition, the electrical producer is required to agree to offer, for use within the state, the first one-half of the amount of power that it produces to Montana customers and distribution services providers at a cost to be set by the Public Service Commission that reflects the producer's cost of generating the electricity plus a reasonable return on investment. The analysis with respect to section 15-24-3001, MCA, is conclusive with respect to this provision. The coal severance tax rate reduction is similar to that construed in <u>Boston Stock Exchange</u> because it is designed to encourage in-state business activity. The decision to offer electricity for sale is statutorily required to be tied to a tax criteria in violation of the Commerce Clause. As in <u>Westinghouse Electric Corporation</u>, the tax rate is tied to the in-state activity of offering electricity for sale in state. In addition, because electricity is involved in the tax rate, section 15-35-103(1)(b), MCA, appears to violate section 15 U.S.C. 391 because the section indirectly results in a greater tax burden on electricity which is generated and transmitted in interstate commerce than on electricity which is generated and transmitted in intrastate commerce. With respect to equal protection analysis, the section is not significantly different from the prior coal severance tax rate reduction contained in the production incentive credit contained in Chapter 636, Laws of 1985 (the window of opportunity). However, the window of opportunity legislation was never challenged. Because section 15-35-103(1)(b), MCA, appears to violate both the Commerce Clause and a federal statute, I do not feel that it is necessary to extensively review its likelihood of withstanding an equal protection challenge.

The third area that you have asked me to address involves the constitutionality of allowing "new business" to receive a specific tax incentive that is not available to an existing business. That type of tax incentive is contained in section 15-24-3001, MCA. As discussed earlier, this type of tax incentive is subject to a rational basis analysis for equal protection purposes.

Article VIII, section 3, of the Montana Constitution provides that the state shall appraise, assess, and equalize the valuation of all property that is to be taxed in the manner provided by law. This section is the crux of the property tax system in Montana and has been the subject of most of the litigation concerning property taxes. The 1975 appraisal plan and its implementing legislation were found constitutional in <u>Patterson v. Department of Revenue</u>, 171 Mont. 168, 557 P.2d 798 (1976). The <u>Patterson</u> Court stated that violation of statutory uniformity requirements generally results in violation of equal protection and due process requirements. The power and duty to equalize values includes the power to alter appraised values that were set at the beginning of an appraisal cycle. Hanley v. Department of Revenue, 207 Mont. 302, 673 P.2d 1257 (1983). In Department of Revenue v. State Tax Appeal Board, 188 Mont. 244, 613 P.2d 691 (1980), the Court held that where it is impossible to secure both the standard of the true value of a taxpayer's property and the uniformity and equality in taxation required by law, the latter requirement is to be preferred as the just and ultimate purpose of the law. Therefore, unequal appraisals may be reduced even though they were an assessment at true market value or 100% of market value as required by 15-8-111. It is my opinion, based upon the analysis of the cited decisions, that Article VIII, section 3, of the Montana Constitution simply requires the state to uniformly administer a method of valuing similar property so that equal valuation is achieved.

As pointed out in analyzing section 15-24-3001, MCA, a statute that encourages the location within the state of needed and useful industries by exempting them, though not also others, from its taxes is not arbitrary and does not violate the Equal Protection Clause of the Fourteenth Amendment. Because of the authority granted to the Legislature in Article VIII, section 5, of the Montana Constitution, legislation exempting any class of property from taxation is likely to be upheld. The 1972 Montana Constitution appears to have reversed the result in Victor Chemical, where the Montana Supreme Court struck down a statute placing industrial property in class 5 for a period of 3 years after it was first assessed. The property then became class 4 property. Class 5 property was taxed at a lower rate than class 4 property. The Court found that the "incentive" was a partial exemption from taxation and not a classification of property. Therefore, because industrial property was not listed in Article XII, section 2, of the 1889 Montana Constitution, the partial exemption was unconstitutional. The "exemption" versus "classification" distinction appears to have been eliminated by the 1972 Montana Constitution. I am unaware of any challenges to Montana statutes that involve the rational basis for placing specific property within a specific class for taxation purposes.

A tax incentive for "new" business would have to be supported by a rational basis. In Stratemeyer v. Lincoln County, 259 Mont. 147, 855 P.2d 506 (1993), the Montana Supreme Court considered an equal protection challenge to Montana workers' compensation law that did not provide coverage for mental stress-related injuries as opposed to injuries having a physical component. The Workers' Compensation Court had declared the portion of the statute precluding stress-related coverage to be a violation of the constitutional guarantee of equal protection. However, the Workers' Compensation Court did not first presume the statute to be constitutional and did not look to any possible legitimate purpose for the law, which is the proper analysis under an equal protection challenge. Applying the rational basis test, the Supreme Court found that the exclusion of mental claims was rationally related to the possible goal of reducing costs and providing a viable program for the state, employers, and employees in the workers' compensation field, which is a legitimate government objective warranting various classifications of work-related injuries and not an equal protection violation. In light of the deferential treatment that is accorded to taxation legislation, any rational basis that can be articulated should be sufficient, so long as the tax incentive is not based upon a suspect classification, such as a reduced tax rate for business owned by certain races.

In conclusion, I am unable to say with any degree of certainty that a tax incentive for "new" business would fail under an equal protection challenge. Each specific tax incentive would have to be analyzed individually. While a person may question the wisdom a policy that places "new business" at an economic advantage over an "existing business", that policy is not automatically a violation of equal protection of the law. See Allied Stores.

I hope that I have adequately addressed your questions. If you have additional questions, please feel free to contact me.

Sincerely,

Gregory J. Petesch
Director of Legal Services

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