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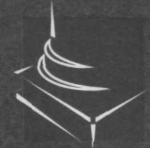

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BULLETIN

ECONOMIC DEVELOPMENT GRANTS LINKED TO PROPERTY TAXES: CONSTITUTIONAL CONCERNS

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The nature of the grants

A number of cities and counties in North Carolina have begun to offer economic development grants linked to the property taxes paid by new businesses. In a typical arrangement, a local government agrees that if a commercial or industrial firm locates a new facility in the jurisdiction and invests a certain amount of money in plant and equipment it will make grants to the business over several years based on a percentage of the taxes paid on the property. For example, a local government might agree that if a firm invests $1 million in plant and equipment, it will make a grant of twenty percent of the taxes paid for five years; if a business invests $5 million, it will make a grant of thirty percent; and so on. When a local government links incentive grants to property taxes in this manner, the local government is in substance refunding part of the taxes paid on the property, and a strong argument can be made that this creates a partial exemption of the property from taxation. Viewed this way, the grants appear to be either an unconstitutional classification and exclusion of property under article V, section 2(2), of the North Carolina Constitution or an unconstitutional exemption under article V, section 2(3). Governing board members who vote for such an unconstitutional exclusion or exemption are liable for the amount of taxes refunded under G.S. 105-380.

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The argument that the grants are unconstitutional

As legal authority for making these grants, local governments have relied on G.S. 158-7.1 and *Maready v. City of Winston-Salem.*[1] G.S. 158-7.1 (a) expressly authorizes cities and counties to make appropriations of tax revenues for the purpose of aiding and encouraging commercial and industrial plants to locate in or near the city or county. *Maready* upheld this authority as being an expenditure of tax funds for a public purpose within the meaning of article V, section 2(1), of the North Carolina Constitution. But neither G.S. 158-7.1 nor *Maready* is authority for linking economic development grants to property taxes, thereby partially exempting property from the tax base. There is no indication that the city and county grants in *Maready* were linked in any way to the amount of property taxes paid, and the court dealt only with the validity of the grants under article V, section 2(1), the public purpose provision. The concern here is the validity of property tax-linked grants under article V, sections 2(2) and 2(3).

Article V, section 2(2), reads:

> Only the General Assembly shall have the power to classify property for taxation, which power shall be exercised only on a State-wide basis and shall not be delegated. No class of property shall be taxed except by uniform rule, and every classification shall be made by general law uniformly applicable in every county, city and town, and other unit of local government.

Article V, section 2(3) reads:

> Property belonging to the State, counties, and municipal corporations shall be exempt from taxation. The General Assembly may exempt cemeteries and property held for educational, scientific, literary, cultural, charitable, or religious purposes, and, to a value not exceeding $300, any personal property. The General Assembly may exempt from taxation not exceeding $1,000 in value of property held and used as the place of residence of the owner. Every exemption shall be on a State-wide basis and shall be made by general law uniformly applicable in every county, city and town, and other unit of local government. No taxing authority other than the General Assembly may grant exemptions, and the General Assembly shall not delegate the powers accorded to it by this subsection.

In summary, these two sections of the constitution provide that only the general assembly may classify property for purposes of taxation and exclude it from the tax base or exempt property from the tax base. Local governments are prohibited from classifying or exempting property, and the general assembly may not delegate its authority to local governments. Furthermore, any classification or exemption that the general assembly makes must be uniform statewide.

These two provisions were added to the constitution in 1962 in substantially their present form.[2] They were proposed as constitutional amendments by the 1958 Commission for the Study of the Revenue Structure of the State, chaired by Senator J.C. Eagles, Jr., to put an end to locally granted exclusions and exemptions from the property tax. One of the commission's findings was this: "Whatever the alleged purpose of the exemption of any property used for business purposes, the effect is to offer a tax benefit as an inducement to this type of business to move into or remain in the county providing the exemption. The exempting county is, therefore, entering into competition with its neighbors, who, in self-defense often feel compelled to grant comparable exemptions."[3] Another finding stated: "The exemption or exclusion of property from taxation adds to the burden of taxation carried by the remaining taxpayers. The preferential treatment of any type of property also results in higher taxes for the owners of property not so favored."[4] Conclusion number three stated: "It is believed that the enactment of local laws exempting or classifying property causes undesirable competition between counties and places a heavier burden of taxation on the remaining taxpayers."[5] Two of the commission's specific recommendations were that the constitution be amended to "remove any doubt" that the power to classify property and to grant exemptions is to be exercised on a state-wide basis only and is not to be delegated to local governments.[6] The commission included drafts of the constitutional amendments needed to accomplish these two

[1] 342 N.C. 708, 467 S.E.2d 615 (1996).

[2] Henry W. Lewis, Property Tax Exemptions and Classifications 10 (Institute of Government 1970).

[3] Report of the Tax Study Commission of the State of North Carolina 6 (Raleigh, N.C. 1958).

[4] Id. at 14.

[5] Id.

[6] Id. at 19.

recommendations, and they were substantially in the form in which they were ratified in 1962.[7]

In light of the legislative history of article V, sections 2(2) and (3), it is plain that one of the major purposes of the two amendments was to bring to a halt the practice of local governments' granting exemptions and exclusions from the property tax, especially as an incentive to attract business investment. The pre-1962 exemptions that were granted may not have been as subtle as linking economic development grants to property taxes paid, but in substance and effect there is no difference between what was being done then and what is being done now. For a county to agree with a taxpayer that for five years it will remit to the taxpayer as an economic development grant fifty percent of the property taxes it pays is in economic result the same as granting the taxpayer an exemption for five years of fifty percent of the assessed value of its property.

If a taxpayer in a city or county that makes economic development grants linked to property taxes should challenge the constitutionality of the grants, and should a court find persuasive the line of reasoning set out above, then the governing board members who voted for the grants could find themselves in serious financial difficulty. G.S. 105-380 provides that any resident of the taxing unit may bring suit against any governing board members who voted for an illegal release or refund of a property tax, and if the suit is successful, the board members will have to pay the amount of the taxes released or refunded and the attorneys' fees of the resident who brought the suit.

The argument that the grants are valid

Of course, a court may not find persuasive the line of reasoning set forth above and hold that the economic development grants examined here are valid. The argument on behalf of their validity goes as follows. It is clear that the intention of sections 2(2) and 2(3) of article V of the constitution was to prohibit the legislature from granting property tax exemptions by local act or from delegating to local governments the authority to grant exemptions on a local basis. Establishing that constitutional intention, however, does not establish that economic development incentives linked to the amount of property taxes paid are an unconstitutional exemption. While it is true that such incentives have an economic effect on the taxpayer little different from a partial exemption from property taxes,[8] the difference in legal structure between the incentive grants and explicit exemptions argues for the validity of the grants. The law is replete with examples in which differences in form lead to differences in legal outcome, even if two forms have the same economic impact. For example, if a county issues certificates of participation to construct a new courthouse, it will use property tax revenues in the general fund to retire the debt evidenced by the certificates, just as it would use property tax revenues in the general fund to retire general obligation bonds issued for the same project. And the county's unwillingness to lose its courthouse or destroy its credit rating means, as a practical matter, that the county's promise to pay debt service for the certificates is effectively as strong as its promise to pay general obligation debt service. Yet, because of the difference in formal security between certificates of deposit and general obligation bonds, only the latter is subject to the constitutional requirement of voter approval.[9]

Similarly, there is a difference in form between an exemption and an incentive grant. With the exemption, the taxpayer pays no tax; but with the incentive grant, the company does in fact pay its property taxes. Only after doing so does it receive the grant, and then only if it has met its contractual obligations to the local government. Under the incentive programs in use in North Carolina, the cash grant is paid in consideration of the economic development investment made by the company. A contract is negotiated between the local government (or governments) and the company, and the company typically agrees to a schedule of investment and jobs creation in consideration of the grants. If it does not meet the schedule, it does not receive the incentive; indeed, if economic conditions cause the company to change its plans and not build or close its facility, the typical agreement requires that the company return any incentives already received.

Furthermore, it seems clear after the *Maready* decision that a local government may make cash grants to a company in order to encourage economic development through the company. The incentives at issue in *Maready* included the following: making site

[7] Id. at Appendix.

[8] Some local governments, in their cash grant incentive policies, have characterized the grant as a "reimbursement" of property taxes. Such a characterization is unfortunate and does lend support to the notion that these are constitutionally the equivalent of a tax exemption.

[9] Wayne County Citizens Ass'n v. Wayne County Board of Commissioners, 328 N.C. 24, 399 S.E.2d 311 (1991).

improvements on company-owned land; paying the cost of relocating utilities on a company-owned site; paying the company's rent on a headquarters' building; paying the cost of moving one private tenant out of a private office building, so that a new private tenant could occupy the space; donating land to a company; and upfitting a privately-owned industrial facility. Each of these involved an expenditure of public funds that directly reduced costs otherwise the responsibility of a private company; each had the consequence of freeing up for other uses company funds that would have had to be used for the public expenditures. Each was constitutional because it caused the benefiting company to locate or expand in Winston-Salem or Forsyth County and increase the employment opportunities and tax base in that community. If it is constitutional to provide incentives by giving a company land worth $1 million, or by paying for $1 million of improvements to a company's land or industrial facility, why would it not be equally constitutional to give the company $1 million in cash, to be used as the company decides? The outlay to the local government is the same, the economic benefit to the company is the same, and the public benefit of jobs and tax base is the same. Therefore, the *Maready* decision clearly supports cash grants to companies in consideration of the companies' locating or expanding in a community.[10] That being the case, the method of measuring the amount of the cash grant should constitutionally irrelevant. If cash grants in general are permissible, *measuring* the grant by the amount of property taxes paid, when property taxes have in fact been paid, should not invalidate the program.

Conclusion and recommendations

Given the uncertain constitutional validity of these cash grant incentives and the potential liability of governing board members if they are found to be invalid, local governments might wish to consider alternative ways of structuring their incentive policies. Tying the amount of any incentive package offered to a company to the amount of investment made by that company in the local community has an obvious appeal, and measuring incentives by the amount of property taxes paid is one way of doing that. Another way to the same end, however, is to refer to the actual investment made rather than to the taxes paid on the investment; that is, incentives might be offered as a percentage of the value of the property rather than as a percentage of property taxes. Removing the direct reference to property taxes paid eliminates the resemblance to an explicit tax exemption and thereby offers greater constitutional protection to the policy. It would be prudent for cities and counties to be very cautious about making economic development grants linked to property taxes until the general assembly has had an opportunity to consider the matter, a prudence that is especially compelling given the liability of board members if they guess wrong.

[10] One of the factors that the court cited in *Maready* in support of its decision was the need to match the kinds of incentives being offered in other states, and grants are clearly used in other states. See, for example, Iowa Code Annotated § 15A.1 (1995), which expressly permits local governments to make grants to private companies in furtherance of economic development. The statute was upheld in Brady v. City of Dubuque, 495 N.W.2d 701 (Iowa 1993). In addition, Oklahoma provides cash grants that are based on a percentage of new payroll created by the recipient company; this program is described in Gorin, "Incentives Project: Oklahoma Quality Jobs Bill," *Economic Development Review*, Fall 1994, pp. 29-34.

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