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A COMMERCE CLAUSE CHALLENGE TO NEW YORK'S TAX DEDUCTION FOR INVESTMENT IN ITS OWN TUITION SAVINGS PROGRAM

Amy Remus Scott*

The Internal Revenue Code provides guidelines for states to create and maintain college tuition savings programs which offer federal tax benefits to investors. Several states have enacted tuition savings plans in accordance with these guidelines. In addition to the federal tax benefits allowed, New York offers a state tax deduction to New York residents who invest in its plan, the New York College Choice Tuition Savings Program. New York does not offer the deduction, however, to residents who invest in comparable programs offered by other states. The tax deduction thus creates an incentive for residents to invest in the in-state program and discriminates against interstate investment in the tuition programs offered by other states. This Note argues that the incentive created by the New York tax deduction violates the United States Constitution by discriminating against interstate commerce.

INTRODUCTION

The Internal Revenue Code allows states to create “qualified State tuition programs”¹ which offer significant federal tax benefits² to individuals who invest in the programs to save for rising college tuition costs. Section 529(b) defines a “qualified State tuition program” (section 529 Plan) as “a program . . . under which a person . . . may make contributions to an account which is

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1. 26 U.S.C. § 529 (1996).

2. Section 529(c)(1) explains that “[e]xcept as otherwise provided in this subsection, no amount shall be includible in gross income of a designated beneficiary under a qualified State tuition program, or a contributor to such program on behalf of a designated beneficiary with respect to any distribution or earnings under such program.” *Id.* § 529(c)(1). Section 529(c)(3) also states that “[a]ny distribution under a qualified State tuition program shall be includible in the gross income of the distributee.” *Id.* § 529(c)(3). Thus, taxation of earnings under the program is deferred until a distribution is made and is included only in the gross income of the distributee (e.g., the child), who typically will be in a lower tax bracket than the contributor (e.g., the parent).

established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account."³ Account owners receive an exemption from federal income tax for any undistributed earnings, and, upon a qualified withdrawal from an account, the interest earned is included in the taxable income of the designated beneficiary, rather than the account owner.⁴ Section 529 Plans allow distributions from program accounts to be used at any approved college or trade school in the country.⁵

New York was one of the first states to enact a section 529 Plan by passing the New York College Choice Tuition Savings Program (New York Savings Program) in 1997.⁶ In addition to the federal tax benefits outlined in section 529,⁷ New York residents who invest in the New York Savings Program also receive a state tax deduction for at least part of their contribution.⁸ Under New York

3. *Id.* § 529(b). A program must meet six other requirements in order to qualify as a "qualified State tuition program": (1) contributions to the program must be made only in cash; (2) the program must impose a "more than de minimis penalty" on any withdrawals from the account not used for qualified higher education expenses; (3) the program must maintain a separate accounting for each designated beneficiary; (4) neither account owners nor designated beneficiaries may direct any investment made by the program; (5) the program must prohibit the designation of any interest in the plan as security for a loan; and (6) the program must provide safeguards to ensure that contributions on behalf of a designated beneficiary do not exceed those necessary to provide for the qualified higher education expenses of that beneficiary. *See id.* § 529(b)(2)-(7).

4. *See id.* § 529(c).

5. "Eligible Education Institution" is defined as "an institution which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. § 1088)." *Id.* § 529(e)(5)(A).

6. *See* N.Y. EDUC. LAW § 695 (McKinney 1997) ("There is hereby established the college choice tuition savings program and such program shall be known and may be cited as the 'New York state college choice tuition savings program.'"). *See* the NEW YORK STATE COLLEGE CHOICE TUITION SAVINGS PROGRAM, PROGRAM BROCHURE 1 (1998) [hereinafter NEW YORK PROGRAM BROCHURE], which outlines the program. It states:

[I]ndividuals participating in the Program . . . establish accounts . . . in a statutory trust fund of which the Comptroller of the State of New York . . . is trustee The Account Owner makes cash contributions to an Account . . . which are invested in a blend of equity, debt and money market instruments. Each Account has a single beneficiary All individuals, regardless of their income level, may contribute. The purpose of the Accounts is to fund 'Qualified Higher Education Expenses' of the Designated Beneficiary. These expenses consist of required tuition, fees, the costs of books, supplies and certain equipment for students enrolled at 'Institutions of Higher Education,' and include certain room and board costs for students attending these institutions on at least a half-time basis. . . . Up to \$100,000 may be contributed under the Program by Account Owners to all Accounts with the same Designated Beneficiary.

Id.

7. *See supra* note 2.

8. Deductions "shall not exceed five thousand dollars." 59 N.Y. TAX LAW § 612(c)(32) (McKinney 1998).

tax law, the "New York adjusted gross income"⁹ of a resident is defined as his federal adjusted gross income, subject to specified modifications.¹⁰ One such modification allows a New York resident to calculate his New York adjusted gross income for a given year by deducting from his federal adjusted gross income any contributions, subject to an annual maximum, that he has made during that taxable year as an account owner to an account established under the New York Savings Program.¹¹

The New York Savings Program and several other states' section 529 Plans are open to residents of any state.¹² Thus, a New York resident may participate in the New York Savings Program or in the section 529 Plan of another state which permits nonresident participation. New York offers a state tax deduction, however, only to its residents who invest in the New York Savings Program.¹³ If a New York resident invests in the New Hampshire College Tuition Savings Plan,¹⁴ for example, New York does not offer her a deduction for her New York state taxes.

New York's state tax deduction creates an incentive for its residents to invest in the New York Savings Program rather than another state's section 529 Plan. A New York resident might otherwise prefer another state's plan if she believes that the other plan is better maintained or has a higher rate of return. New York thus creates a preference for its in-state section 529 Plan. This incentive raises the concern that New York is discriminating against interstate

9. *Id.* § 612(a). The "New York adjusted gross income" is the tax base to which the New York tax rates are applied.

10. *See* 59 N.Y. TAX LAW § 612(a) (McKinney 1998).

11. *See id.* § 612(c)(32). The section states:

There shall be subtracted from federal adjusted gross income: . . . Contributions made during the taxable year by an account owner to one or more family tuition accounts established under the New York state college choice tuition savings program . . . provided, however, the contributions by the owner of an account or accounts for the taxable year shall not exceed five thousand dollars.

Id.

12. *See, e.g.*, NEW YORK PROGRAM BROCHURE, *supra* note 6, at 4 (stating that "[t]he Program is not restricted to residents of New York"); Kristin Davis, *How to Ace Saving for College*, KIPLINGER'S PERS. FIN. MAG., Feb. 1999, at 88, 90-92 (stating that the following state plans accept investment from residents of any state: Delaware, Indiana, Iowa, Maine, Montana, New Hampshire, New York, Rhode Island, and Utah; other states—including Connecticut, New Jersey, Texas, and Vermont—offer Savings Plans only to state residents).

13. *See* 59 N.Y. TAX LAW § 612(c)(32) (McKinney 1998) (specifying a state tax deduction only for investment in the New York state college choice tuition savings program).

14. *See* N.H. REV. STAT. ANN. § 195-H (1997).

commerce in violation of Article I, Section 8 of the U.S. Constitution.¹⁵

Courts have decided numerous Commerce Clause cases involving questions of state taxation.¹⁶ These cases typically have addressed state taxes favoring in-state, over out-of-state, private businesses.¹⁷ This Note addresses the proper application of the Commerce Clause to a state tax deduction that discriminates in favor of the state itself.¹⁸

This Note concludes that a state's grant of a tax deduction solely for investment in its own section 529 Plan and not for investment in out-of-state section 529 Plans is an unconstitutional restriction of interstate commerce. Part I reviews the dormant Commerce Clause generally and as applied to state tax plans and finds that the state tax deduction for investment only in an in-state section 529 Plan would be unconstitutional if the section 529 Plans were private enterprises. Part II argues that the New York tax deduction favors the state, as opposed to private businesses within the state. Part II also offers and then rejects the idea that the state is distributing state-created benefits which would exempt it from Commerce Clause restraints. Part III describes the market participant exception to the dormant Commerce Clause and determines that the exception does not apply to the New York deduction for investment in section 529 Plans. In addition, Part III argues that, in offering the New York Savings Program, the state is performing "private-type" activity and that state regulation of this activity, like state regulation favoring in-state private businesses, should be

15. See U.S. CONST. art. I, § 8, cl. 3 ("The Congress shall have power . . . [t]o regulate Commerce . . . among the several States."); *infra* Part I.A (discussing the dormant Commerce Clause).

16. See, e.g., *Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine*, 520 U.S. 564, 593 (1997) (holding that an exemption statute which singled out charitable institutions that served mostly state residents for beneficial tax treatment and penalized those institutions that performed principally interstate business violated the dormant Commerce Clause); *Fulton Corp. v. Faulkner*, 516 U.S. 325, 327 (1996) (holding that North Carolina's intangibles tax on the fraction of the value of corporate stock owned by state residents, charged at a rate inversely proportional to the corporation's exposure to the State's income tax, facially discriminated against interstate commerce in violation of the dormant Commerce Clause); *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 332 (1977) (holding that a tax which imposed greater liability on out-of-state sales than on in-state sales discriminated against interstate commerce in violation of the Commerce Clause).

17. See *supra* note 16.

18. See Scott K. Attaway, *The Case for Constitutional Discrimination in Taxation of Out-of-State Municipal Bonds*, 76 B.U. L. REV. 737, 756-68 (1996) (discussing this idea in the context of state-issued municipal bonds); Maxwell A. Miller & Mark A. Glick, *The Resurgence of Federalism: The Case for Tax-Exempt Bonds*, 1 TEX. REV. L. & POL. 25 (1997); *infra* Parts II.A-B, III.B (evaluating the municipal bond scenario as it relates to the question presented in this Note).

invalid under Commerce Clause restraints. This Note concludes that the state tax deduction offered only for investment in an in-state section 529 Plan violates the Commerce Clause.

I. THE DORMANT COMMERCE CLAUSE AND STATE TAXATION

A. *The Dormant Commerce Clause*

The Commerce Clause of the U.S. Constitution states that "Congress shall have [p]ower . . . [t]o regulate Commerce . . . among the several States."¹⁹ Although stated as an affirmative power of Congress, the Clause places a "dormant" limit on the power of the states.²⁰ The Supreme Court has explained that, "[t]hough phrased as a grant of regulatory power to Congress, the Clause has long been understood to have a 'negative' aspect that denies the States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce."²¹ The negative aspect derives from the clause's purpose, to protect the welfare of the Nation as a unified whole by checking the states' ability to retreat into economic isolation.²² The dormant Commerce Clause reflects the Constitutional framers' desire to avoid the economic balkanization of the states that occurred under the Articles of Confederation.²³ The Supreme Court has emphasized that "[t]he very purpose of the Commerce Clause was to create an area of free trade among the several States"²⁴ and that "this Nation is a common market in which state lines cannot be made barriers to the free flow of . . . goods in response to the economic laws of supply

19. U.S. CONST. art. I, § 8, cl. 3.

20. See *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179 (1995) ("Despite the express grant to Congress of the power to 'regulate Commerce . . . among the several States,' we have consistently held this language to contain a further, negative command, known as the dormant Commerce Clause, prohibiting certain state taxation even when Congress has failed to legislate on the subject." (citation omitted)). *But see* Martin H. Redish & Shane V. Nugent, *The Dormant Commerce Clause and the Constitutional Balance of Federalism*, 1987 DUKE L.J. 569, 574 (arguing that the dormant Commerce Clause has no basis in the Constitution).

21. *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 511 U.S. 93, 98 (1994) (holding that Oregon's imposition of a greater per ton surcharge on in-state disposal of solid waste generated in other states than on disposal of waste generated within Oregon was facially invalid under the negative Commerce Clause). For examples of when a state may *justifiably* discriminate against interstate commerce, see *infra* notes 50–57 and accompanying text.

22. See *Oklahoma Tax Comm'n*, 514 U.S. at 179–80.

23. See *id.*

24. *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327, 330 (1944).

and demand.”²⁵ The underlying principle of the dormant Commerce Clause is that states may not disfavor the flow of commerce across state lines.

*B. The Dormant Commerce Clause as Applied to
State Taxation of Private Businesses*

Courts consistently have held that states may not impose a tax that restricts interstate commerce by providing a direct commercial advantage to private, local businesses.²⁶ The Supreme Court has held that state laws which facially discriminate in favor of in-state businesses and against interstate commerce are subject to a “virtually *per se* rule of invalidity.”²⁷ The Court held in *Bacchus Imports, Ltd. v. Dias*²⁸ that the prohibition of any tax which discriminates against interstate commerce by favoring local businesses is a “cardinal rule of Commerce Clause jurisprudence.”²⁹ In *Complete Auto Transit, Inc. v. Brady*,³⁰ the Court established that a valid state tax cannot “discriminate[] against interstate commerce.”³¹ The *Brady* court emphasized the need to focus on the practical effects of a tax and not just the language or technical structure of the statute.³²

A tax discriminates against interstate commerce, according to the Supreme Court, if it involves “differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.”³³ The Court has emphasized that a tax is discriminatory if it forecloses a tax-neutral decision.³⁴ In other words,

25. *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 803 (1976).

26. *See supra* note 16.

27. *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 511 U.S. 93, 100 (1994).

28. 468 U.S. 263 (1984).

29. *Id.* at 268.

30. 430 U.S. 274 (1977).

31. *Id.* at 287. The four-pronged test used by the *Brady* court to establish the validity of a state tax requires that: (1) there is a substantial nexus between the activity taxed and the taxing state; (2) the tax is fairly apportioned based on activity conducted in the taxing state; (3) the tax is related to services provided by the state; and (4) the tax does not discriminate against interstate commerce. *See id.*

32. *See id.* at 288–89.

33. *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 511 U.S. 93, 99 (1994).

34. *See, e.g., Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 406 (1984) (stating that whether a “tax diverts new business into the State or merely prevents current business from being diverted elsewhere, it is still a discriminatory tax that ‘forecloses tax-neutral decisions[.]’”); *Boston Stock Exch. v. State Tax Comm’n.*, 429 U.S. 318, 331 (1977) (stating that a discriminatory New York transfer tax on securities regulations “forecloses tax-neutral decisions and creates both an advantage for the exchanges in New York and a discriminatory

a tax incentive which favors in-state activity is discriminatory if a decision-maker cannot reasonably ignore it when choosing between in-state and out-of-state activities. In *Smith v. New Hampshire Department of Revenue Administration*,³⁵ the New Hampshire Supreme Court struck down an interests and dividends tax that provided tax benefits for investment at in-state banks but not for investment at out-of-state banks.³⁶ Relying on Supreme Court decisions in *Boston Stock Exchange v. State Tax Commission*³⁷ and *Oklahoma Tax Commission v. Jefferson Lines, Inc.*,³⁸ the court held that the "tax's distinction between in-state and out-of-state banks is unconstitutional because a New Hampshire depositor's decision about whether to invest in a domestic or foreign bank is not governed by tax-neutral criteria."³⁹ The court concluded that the tax "violates the principle that state statutes may not constitutionally encourage the development of local industry by means of taxing measures that impose greater burdens on economic activities taking place outside the State than would be placed on similar activities within the State."⁴⁰ By offering the tax deduction only to certain residents—those who select New York's section 529 Plan—the state has ensured that New York residents interested in investing in a section 529 Plan will consider the tax deduction in trying to achieve the highest post-tax return. By making the tax deduction a significant factor in the selection of a tuition plan, New York has foreclosed tax-neutral decisions by potential plan participants.⁴¹

Even commentators who contend that the Court's tax-neutral requirements "should be read less expansively than their literal language permits"⁴² offer an explanation that would invalidate the New York tax deduction as applied to private businesses. They argue that two core principles underlie the Court's state tax

burden on commerce to its sister States"); *Smith v. New Hampshire Dep't. of Revenue Admin.*, 692 A.2d 486, 497 (N.H. 1997) (holding that a state interests and dividends tax was unconstitutional because "New Hampshire residents have a strong economic incentive to invest in banks located within the State").

35. 692 A.2d 486 (N.H. 1997).

36. *See id.* at 497.

37. 429 U.S. at 318, 329 (1977) ("No State, consistent with the Commerce Clause, may 'impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.'").

38. 514 U.S. 175, 179–80 (1995) (stating that the dormant aspect of the Commerce Clause supports the goal of preventing states from retreating into economic isolation).

39. *Smith*, 692 A.2d at 497.

40. *Id.* at 497; *see also Boston Stock Exch.*, 429 U.S. at 329.

41. For example, New York residents will not select a plan based solely on the highest returns or the best investment record but will also take into account the New York state tax benefit in calculating their final rate of return on the investment.

42. Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 CORNELL L. REV. 789, 805 (1996).

incentive decisions: “[f]irst, the provision must favor in-state over out-of-state activities; second, the provision must implicate the coercive power of the state.”⁴³ Referring to the Supreme Court’s decision in *Westinghouse Electric Corp. v. Tully*,⁴⁴ commentators explain that the “clear thrust of the opinion was that any provision that reduces the taxpayer’s ‘effective [in-state] tax rate’ as the taxpayer engages in more in-state activity violates the Commerce Clause.”⁴⁵ Thus, state income tax deductions which favor in-state activity “implicate the coercive power of the state, because the taxpayer can reduce its state tax bill only by engaging in in-state activity,”⁴⁶ and thus do not satisfy Commerce Clause review.

The Supreme Court’s repeated prohibitions of state taxes discriminating against interstate commerce have addressed taxes that favor in-state private businesses.⁴⁷ The Court has been emphatic that a state may not impose a tax on interstate commerce that provides a direct commercial advantage to local businesses.⁴⁸ Thus, if the section 529 Plans discussed here were run as private businesses, a tax discriminating against the out-of-state plans would be indistinguishable from the many taxes the Court has previously invalidated.⁴⁹ A state tax favoring investment in a private in-state tuition savings plan over investment in a private out-of-state tuition savings plan would be invalid.

Even a facially discriminatory tax may survive, however, under certain circumstances. If an otherwise discriminatory tax is compensatory, such that it actually causes interstate commerce to bear a burden already borne by intrastate commerce, courts will uphold it.⁵⁰ For example, if a state exacts an additional fee from out-of-state waste producers who enter the state to dispose of their garbage, the tax might be justified as a compensatory measure if in-state waste producers contribute to the state’s waste disposal facility

43. *Id.* at 806.

44. 466 U.S. 388 (1984).

45. Hellerstein & Coenen, *supra* note 42, at 815.

46. *Id.* at 817.

47. See *supra* text accompanying notes 26–32.

48. See *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 272 (1984) (stating that while “competition among the States for a share of interstate commerce is a central element of our free-trade policy . . . a State may not tax interstate transactions in order to favor local businesses over out-of-state businesses”).

49. See *supra* text accompanying notes 26–32.

50. In *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), the Court held that there are three conditions necessary for a valid compensatory tax: first, a state must identify the intrastate tax burden for which the state is trying to compensate; second, the tax on interstate commerce must be roughly equal to—and must not exceed—the tax on intrastate commerce; and third, the events on which the intrastate and interstate taxes are imposed must be substantially equivalent. See *id.* at 332–33.

costs through other state taxes.⁵¹ The rationale behind this doctrine is that "a facially discriminatory tax that imposes on interstate commerce the rough equivalent of an identifiable and 'substantially similar' tax on intrastate commerce does not offend the negative Commerce Clause."⁵² The New York tax deduction, however, is not a compensatory measure. A measure is compensatory when the state requires parties that cross state lines to bear a burden that parties not crossing state lines already bear. A New York resident investing in an out-of-state section 529 Plan does not gain any benefit equivalent to the one that New York offers to residents investing in the New York Savings Program. The New York tax deduction discriminates against interstate commerce with no compensatory justification.

Another possible basis for upholding an otherwise discriminatory tax is that the state is offering a subsidy to its residents that the courts should protect.⁵³ Although the Supreme Court has suggested that direct subsidization is an acceptable means of supporting intrastate commerce,⁵⁴ courts and commentators have distinguished tax benefits from protected subsidies.⁵⁵ In *New Energy Co. v. Limbach*,⁵⁶ the Court stated:

The Commerce Clause does not prohibit all state action designed to give its residents an advantage in the marketplace, but only action of that description *in connection with the State's regulation of interstate commerce*. Direct subsidization of domestic industry does not ordinarily run afoul of that prohibition; discriminatory taxation of out-of-state manufacturers does.⁵⁷

51. See *Chemical Waste Management, Inc. v. Hunt*, 504 U.S. 334, 346 n.9 (1992) (discussing this possible defense, which the state did not present).

52. *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 511 U.S. 93, 102-03 (1994).

53. While there is no crystal clear statement from the Court as to which subsidization programs are acceptable, "[t]oday, every state provides tax and other economic incentives as an inducement to local industrial location and expansion." Hellerstein & Coenen, *supra* note 42, at 790.

54. See *infra* note 57 and accompanying text; see also *West Lynn Creamery v. Healy*, 512 U.S. 186, 199 (1994) (holding that, while the subsidy in question violated the Commerce Clause, in general, "[a] pure subsidy funded out of general revenue ordinarily imposes no burden on interstate commerce, but merely assists local business").

55. See Hellerstein & Coenen, *supra* note 42, at 868 ("[C]ourts applying the dormant commerce clause should approach tax breaks and subsidies very differently."). But see Donna D. Adler, *The Internal Revenue Code, the Constitution and the Courts: The Use of Tax Expenditure Analysis in Judicial Decision Making*, 28 WAKE FOREST L. REV. 855, 855 (1993) (arguing that tax expenditures should be treated as subsidies).

56. 486 U.S. 269 (1988).

57. *Id.* at 278.

For example, in *Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine*,⁵⁸ the Supreme Court held that a property tax exemption for charitable organizations within Maine violated the Commerce Clause, because it excluded organizations that operated principally for the benefit of non-residents.⁵⁹ While the dissent argued that this tax exemption should be viewed as a permissible subsidy for charities focusing on in-state beneficiaries,⁶⁰ the majority held that a tax exemption for one party is a discriminatory tax on another party.⁶¹

Although the practical impact of a subsidy and a tax may be the same, “[a] host of commentators have defended the distinction on the basis of history and policy.”⁶² The distinction between taxes and subsidies “reflects the ‘important economic reality’ that subsidy payments are inherently ‘expensive’ and signal a cost ‘directly borne internally’ by the state.”⁶³

Subsidies do not distort local politics nearly as effectively as do protectionist regulations and taxes or transportation regulations While the general consumer interest is a weak restraint on regulation that raises prices, the general taxpayer interest is stronger This in turn disciplines legislatures to be more cautious when they spend than when they regulate.⁶⁴

In addition, “the distinction springs from the origins of the Commerce Clause itself, for the Clause grew out of concerns about abusive taxation.”⁶⁵ Discriminatory state subsidy programs may be permissible under the Commerce Clause, but courts will not treat state tax deductions like state subsidies. Based on the distinction

58. 520 U.S. 564 (1997).

59. See *id.* at 589.

60. See *id.* at 603–04 (Scalia, J, dissenting) (“Our cases have always recognized the legitimacy of limiting state-provided welfare benefits to bona fide residents.”).

61. See *id.* at 583 n.16, stating that:

Maine has ample alternatives . . . to achieve its apparent goal of subsidizing the attendance of the State’s children at summer camp. Maine could, for example, achieve this end by offering direct financial support to parents of resident children. Though we have not had the occasion to address the issue, it might also be permissible for the State to subsidize Maine camps directly to the extent that they serve Maine residents.

Id. (citations omitted).

62. Hellerstein & Coenen, *supra* note 42, at 846.

63. *Id.* at 846–47.

64. Richard B. Collins, *Economic Union as a Constitutional Value*, 63 N.Y.U. L. REV. 43, 102–03 (1988) (footnote omitted).

65. Hellerstein & Coenen, *supra* note 42, at 847.

that courts and commentators have drawn between direct subsidization and taxation,⁶⁶ the New York tax deduction does not qualify as a subsidy and should be subject to Commerce Clause restraints.

The New York tax deduction for contributions to the New York Savings Program is facially discriminatory. The deduction discriminates in favor of the New York Savings Program and against investment in another state's section 529 Plan.⁶⁷ The New York tax deduction also does not qualify as a compensatory measure or as a state subsidy. Since it does not equalize burdens placed on intra-state and interstate commerce it is not a permissible compensatory measure.⁶⁸ Similarly, under the distinction drawn by courts and commentators between state subsidies and taxes, the New York deduction is not a permissible state subsidy.⁶⁹

Thus, if the New York Savings Program were a privately-run business, definitive authority would support the conclusion that the state tax deduction favoring the New York Savings Program would not survive Commerce Clause review. The remainder of this Note addresses whether that result changes because the section 529 Plan is run by the state.

II. THE NEW YORK TAX DEDUCTION—A STATE'S PREFERENCE FOR ITSELF

A. *The State Favoring Itself Over Other States*

The New York tax deduction for investment in the New York Savings Program favors the state itself (by favoring the state-run savings plan) and thus gives the state a competitive advantage over other states.⁷⁰ As discussed in Part I.B of this Note, if a state's tax

66. See *supra* note 55 and accompanying text.

67. See *supra* notes 11–14 and accompanying text.

68. See *supra* notes 50–52 and accompanying text.

69. See *supra* notes 53–61 and accompanying text.

70. This direct state competition is unusual. One author comments that "states do not ordinarily compete with each other for customers in the way Coca-Cola and Pepsi-Cola compete." Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091, 1113 (1986). The more typical scenario involves a state tax favoring in-state citizens and their private businesses: for example, a higher state tax imposed on products produced out-of-state and imported than on competing products produced in-state. See, e.g., *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 511 U.S. 93, 98 (1994) (holding that Oregon's imposition of a greater per ton surcharge on in-state disposal of solid waste generated in other states than on disposal of waste generated within Oregon was facially invalid under the negative Commerce Clause); *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 332 (1977) (holding that a tax which im-

policy were to favor in-state private businesses or citizens over out-of-state private businesses or citizens, its action would be unconstitutional.⁷¹ The state's role in offering a section 529 Plan raises the question whether a state's preference for itself, as opposed to private in-state businesses, should lead to a different conclusion.

In *Shaper v. Tracy*,⁷² the Ohio Court of Appeals addressed a similar preference for a state itself. The court evaluated an Ohio statute that defined state adjusted gross income as including the interest and dividends on obligations or securities of any state or political subdivision, but then exempted interest earned on bonds issued by the state of Ohio and its political subdivisions.⁷³ The effect of this statute was a preference for Ohio bonds over bonds issued by other states. The court explained that “[t]he instant action does not involve a taxation scheme whereby the citizenry of Ohio are provided with a competitive advantage over the citizenry of other states. Rather, the taxation scheme in the instant action benefits the state of Ohio itself.”⁷⁴

Similarly, the New York tax deduction for contributions made to the New York Savings Program does not provide citizens of New York with a competitive advantage over citizens of other states, but instead creates a preference for the state of New York itself, as the offeror of the New York Savings Program.⁷⁵ If the state were to provide tax benefits for investment in private investment plans within the state, those benefits would provide an advantage to private businesses offering in-state investment plans over private businesses offering out-of-state investment options. The New York tax deduction similarly favors the party offering the New York Savings Program. In this case, however, the favored party is not a private citizen running a business, but instead is the state itself.

posed greater liability on out-of-state sales than on in-state sales discriminated against interstate commerce in violation of the Commerce Clause).

71. See *supra* Part I.B.

72. 647 N.E.2d 550 (Ohio Ct. App. 1994).

73. See *id.* at 551 (evaluating OHIO REV. CODE ANN. § 5747.01(A)(1) (Anderson 1998)).

74. *Id.* at 553.

75. There are no private citizens running the savings plan who will benefit from their “in-state” status. Only the state itself benefits, as the party offering the Plan, at the expense of any other states which offer section 529 Plans. The state gains a competitive advantage over out-of-state plans due to the favorable tax deduction. The New York Savings Program may attract more investors, who might otherwise have invested in out-of-state plans, due to the favorable tax treatment imposed by New York. The discrimination here is not between in-state and out-of-state private individuals or businesses, but between in-state and out-of-state state-sponsored Plans. The benefit of the New York tax deduction is conferred on the state, not in its regulatory role, but in its role as the party offering the New York Savings Program as an investment vehicle.

The *Shaper* court held that the discriminatory tax preference was constitutional.⁷⁶ Without providing any significant analysis for its conclusion,⁷⁷ the court simply stated:

[W]e agree with the trial court's rationale that 'neither the Supreme Court nor any case law examined has applied the Commerce Clause to actions between governmental entities'. . . . Given the lack of any precedent to apply the Commerce Clause to this type of taxation scheme, we are unable to find [the statute] unconstitutional as violative of the Commerce Clause.⁷⁸

Other Commerce Clause opinions suggest, however, that New York's discrimination against out-of-state section 529 Plans in favor of the New York Savings Program does violate the principles of the dormant Commerce Clause and should be held unconstitutional.⁷⁹

The dormant Commerce Clause represents a deeply entrenched concern for maintaining free trade among the states and for protecting the welfare of the nation as a whole.⁸⁰ Because the New York tax deduction is offered solely for investment in the New York Savings Program, it discriminates against out-of-state section 529 Plans and interferes with free trade across state lines.⁸¹ The tax deduction provides a competitive advantage to the New York Savings Program because citizens who want to maximize their overall return on college savings investment will rationally have to consider any tax savings they may experience with the New York Savings

76. *See Shaper*, 647 N.E.2d at 553–54.

77. For a commentary on the puzzling nature of the court's "failure to tie its reasoning to any constitutional doctrine," see Attaway, *supra* note 18, at 739 n.6. The author comments that:

While articulating the legitimate state purpose of providing an incentive for residents to invest in in-state bonds, the court made no attempt to explain why the means chosen to achieve this purpose—a tax exemption that discriminates against income earned from out-of-state bonds—is permissible under the Commerce Clause.

Id.

78. *Shaper*, 647 N.E.2d at 553–54.

79. *See infra* Parts II.B and III.

80. *See supra* Part I.A.

81. The tax deduction is discriminatory because it exempts investments made in the New York plan but not in plans offered by other states. The deduction interferes with interstate trade by providing strong incentives for New York residents to invest in the in-state plan and not cross state lines to invest in other plans. *See supra* Introduction (detailing the New York tax deduction). New York may have a valid state interest in creating incentives for state residents to invest and prepare for tuition expenses. That interest could be served in a non-discriminatory manner, however, by offering the state tax deduction for investment in section 529 Plans of every state.

Program that they will not experience with any other Plan. That tax savings will be a significant factor in their choice of a section 529 Plan and will deter investment in out-of-state section 529 Plans.⁸² The question, then, is whether there are other compelling reasons to place New York's discriminatory tax preference outside the confines of Commerce Clause review.⁸³

B. No Distribution of State-Created Benefits

States may act in protectionist ways when distributing state-created benefits.⁸⁴ This principle typically applies when a state restricts the benefits of state-run programs like schools, fire protection, and energy to state residents.⁸⁵ The underlying idea is that the purpose of state government is to serve the people of the state.⁸⁶ Although not articulated by the Ohio court, this may be a rationale for the *Shaper* decision.⁸⁷ In the context of state-issued municipal bonds, residents of the state benefit in proportion to the number of people who invest in the state's own municipal bonds.⁸⁸ Residents across the state benefit from the programs that are funded by the sale of the state's bonds.⁸⁹ Contrary to the municipal bond scenario raised in *Shaper*,⁹⁰ however, the New York tax deduction does not affect the distribution of state-created benefits. The money invested in the New York Savings Program is invested for

82. See *supra* Part I.B (discussing the illegitimacy of a tax that forecloses tax-neutral decisions).

83. See *C & A Carbone, Inc. v. Town of Clarkstown, New York*, 511 U.S. 383, 389 (1994) ("The real question is whether the [state action] is valid despite its undoubted effect on interstate commerce."); *Regan*, *supra* note 70, at 1100 ("[T]here are other national interests that may be involved in . . . taxation cases.").

84. See *Attaway*, *supra* note 18, at 756 ("The distribution of state created benefits is another area where states may permissibly burden interstate commerce.").

85. Commenting on "rules restricting to state residents the enjoyment of state educational institutions, energy generated by a state-run plant, police and fire protection, and agricultural improvement and business development programs," *Reeves, Inc. v. Stake*, 447 U.S. 429, 442 (1980), the Court stated that "[s]uch policies, while perhaps 'protectionist' in a loose sense, reflect the essential and patently unobjectionable purpose of state government—to serve the citizens of the State." *Id.*

86. See *id.*

87. See *Shaper v. Tracy*, 647 N.E.2d 550 (Ohio Ct. App. 1994).

88. See *Attaway*, *supra* note 18, at 740–41 (commenting that states generally use municipal bonds to fund desirable capital projects in order to spread the cost of the projects across all those who will benefit from them over time).

89. For example, state residents may enjoy the benefits of a new school built with money raised through state-issued municipal bonds.

90. See *Shaper*, 647 N.E.2d at 551.

the benefit of the investor and is not used by the state.⁹¹ In fact, New York makes no profit on the New York Savings Program.⁹² Residents of New York as a whole will not be differently affected if a resident invests in an in-state or out-of-state section 529 Plan and will not gain any benefit from increased investment in the New York Savings Program.⁹³ Although discrimination against interstate commerce may be allowed "in a narrow class of cases in which the [state or] municipality can demonstrate, under rigorous scrutiny, that it has no other means to advance a legitimate local interest,"⁹⁴ the relevant local interest here—to aid individuals in preparing for the costs of higher education⁹⁵—can be satisfied without any limitations on the free flow of interstate commerce. Thus, the New York tax deduction is not immune to the dormant Commerce Clause limitations imposed on the states. Part III examines whether the state's involvement in the private-type investment plan saves it from a Commerce Clause violation.

91. The money is invested, depending on the number of years until the projected withdrawal from the account, in a series of varying percentage combinations of three underlying portfolios: the College Savings Growth Fund, the College Savings Bond Fund, and the College Savings Money Market Fund. *See* NEW YORK PROGRAM BROCHURE, *supra* note 6, at 14. Teachers Advisors, Inc., a wholly-owned subsidiary of Teachers Insurance and Annuity Association (TIAA), serves as the program manager. *See id.* at 2.

92. *See id.* at 29 (explaining that "[n]either the Comptroller nor HESC [N.Y. Higher Education Services Corporation] is permitted to earn any profit at any time or in any manner from or relating to the Program"). The Comptroller and the HESC are the state bodies responsible for implementing the Program. *See id.* at 7. The only fee associated with the current Program is a management fee equal to 0.65% of the average daily net assets of each of the underlying portfolios, to be paid to TIAA for its services in connection with the Program. *See id.* at 29.

93. Unlike municipal bonds which raise money for a state to fund services for all of its residents, the New York Savings Program does not raise any money for the state and results in no benefits to the taxpayers in general. There is no state revenue generated from the New York Savings Program that might be used to fund state programs or social services. *See supra* note 92 and accompanying text.

94. *C & A Carbone, Inc. v. Town of Clarkstown, New York*, 511 U.S. 383, 392 (1994).

95. *See* NEW YORK STATE PROGRAM BROCHURE, *supra* note 6, at 1 (stating that the Program has been "established to enable residents of New York and other states . . . to fund qualified higher education expenses").

III. THE NEW YORK TAX DEDUCTION—A COMMERCE CLAUSE VIOLATION

A. *The Market Participant Exception*

In an attempt to balance states' rights with the legitimate goal of a free market across state lines,⁹⁶ the Supreme Court has developed an exception to dormant Commerce Clause restrictions when a state itself participates in a particular market.⁹⁷ State activity that would otherwise fail Commerce Clause review will be upheld if it falls within this exception. Part III demonstrates that the New York tax deduction given only for investment in the in-state section 529 Plan does not fall within this exception and is not excused from the dormant Commerce Clause restrictions explained in Part I.

The Supreme Court has held that states may discriminate explicitly in favor of local interests when the states act not as market regulators, but as market participants.⁹⁸ "The Court has reasoned that when states expend their resources in conducting ordinary business activities, they should be as free as private businesses to decide with whom they wish to deal."⁹⁹ In justifying this exception, the Supreme Court stated that, "[n]othing in the purposes animating the Commerce Clause prohibits a state, in the absence of congressional action, from participating in the market and exercising the right to favor its own citizens over others."¹⁰⁰

The leading market participant case, *Hughes v. Alexandria Scrap Corp.*,¹⁰¹ involved a Maryland program designed to encourage the recycling of abandoned cars.¹⁰² Maryland offered a bounty on abandoned cars, but the requirements for obtaining the bounty were more burdensome for out-of-state processors than for in-state

96. See *supra* notes 22–25 and accompanying text.

97. In *Reeves, Inc. v. Stake*, 447 U.S. 429 (1980), the Court noted that the market participant rule was based on the role that each state must play "as guardian and trustee for its people" as well as on the idea that private traders have a right to choose their trading partners. See *id.* at 438–39.

98. See *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 810 (1976); Dan T. Coenen, *Untangling the Market-Participant Doctrine*, 88 MICH. L. REV. 395, 441 (1989) (explaining that the market participant exception applies to the question whether dormant Commerce Clause restraints apply when states prefer local interests in choosing their own trading partners).

99. Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 441 (1996).

100. *Hughes*, 426 U.S. at 810.

101. 426 U.S. 794 (1976).

102. See *id.* at 799–800.

processors.¹⁰³ The Supreme Court found that Maryland entered “as a purchaser, in effect, of a potential article of interstate commerce . . . [and restricted] its trade to its own citizens or businesses within the State.”¹⁰⁴ The Court held that, although there had been a resulting impact on the flow of interstate commerce, Maryland’s actions were acceptable because the state “ha[d] not sought to prohibit the flow of hulks, . . . [but] [i]nstead, it ha[d] entered into the market itself to bid up their price.”¹⁰⁵ Accordingly, Maryland could favor local scrap producers over out-of-state producers, because the state was competing in the market for scrap automobiles.¹⁰⁶

The Supreme Court similarly upheld discriminatory actions in favor of states exercising a preference for hiring in-state workers¹⁰⁷ and restricting the sale of cement to in-state residents.¹⁰⁸ In *White v. Massachusetts Council of Construction Employers, Inc.*,¹⁰⁹ the Supreme Court held that an executive order of the Mayor of Boston requiring that all city-funded construction projects be performed by a workforce at least half of whom were city residents did not violate the dormant Commerce Clause.¹¹⁰ The majority explained that a hiring preference for local workers was acceptable, because the city was acting as a participant in the construction market, and “when a state or local government enters the market as a participant it is not subject to the restraints of the Commerce Clause.”¹¹¹ Similarly, in *Reeves, Inc. v. Stake*,¹¹² the Court held that a South Dakota policy confining the sale of cement produced at state-owned plants to state residents did not violate the Commerce Clause, because “South Dakota, as a seller of cement, unquestionably fits the ‘market participant’ label.”¹¹³ Thus, if a state acts like any other private actor in the marketplace, the state is free from Commerce Clause restrictions. As the Court explains,

103. Maryland offered the bounty on hulks in order to increase the value of the hulks and the likelihood that they would be recycled. The state’s requirements for establishing title to the hulks in order to receive the bounty were less stringent for in-state than for out-of-state processors. *See id.* at 800–01.

104. *Id.* at 808.

105. *Id.* at 806.

106. *See id.* at 809–10.

107. *See White v. Massachusetts Council of Constr. Employers, Inc.*, 460 U.S. 204, 214 (1983); *infra* text accompanying notes 110–11.

108. *See Reeves, Inc. v. Stake*, 447 U.S. 429, 446 (1980); *infra* text accompanying note 113.

109. 460 U.S. 204 (1983).

110. *See id.* at 206.

111. *Id.* at 208.

112. 447 U.S. 429 (1980).

113. *Id.* at 440.

“when acting as proprietors, States should . . . share existing freedoms from federal constraints, including the inherent limits of the Commerce Clause.”¹¹⁴

The underlying rationale for the market participant exception supports characterization of the New York Savings Program as private-type activity. The premise of the market participant exception is that states can and do act as private market participants.¹¹⁵ The New York Savings Program is a clear example of such private-type activity. The New York Savings Program takes the form of a standard mutual fund investment.¹¹⁶ Establishing and maintaining a mutual fund is not an inherently sovereign activity but is, in its traditional form, a private business.¹¹⁷ Like any private business, the state is free from Commerce Clause restraint when it establishes and maintains the New York Savings Program.¹¹⁸ For example, the state is free to offer its plan only to state residents, even though it would explicitly favor local interests to the exclusion of interstate interests.¹¹⁹ Just as “South Dakota, as a seller of cement, unquestionably fit[] the ‘market participant’ label,”¹²⁰ New York, as an offeror of investment accounts, is unquestionably engaged in private-type activity in the investment market. Complications arise, however, when states act simultaneously as market participants and as market regulators.¹²¹

114. *Id.* at 439.

115. *See id.* at 436–37 (“[T]he Commerce Clause responds principally to state taxes and regulatory measures impeding free private trade in the national marketplace. . . . There is no indication of a constitutional plan to limit the ability of the States themselves to operate freely in the free market.”).

116. Contributions made to the New York State College Choice Tuition Savings Program are “invested . . . in special portfolios. . . . These portfolios use stocks, bonds and money market instruments in an effort to achieve an appropriate mix of growth and safety. . . . As with other equity and debt investments, the value of [the] Account is neither insured nor guaranteed and will fluctuate in accordance with the returns of the underlying securities.” NEW YORK STATE COLLEGE CHOICE TUITION SAVINGS PROGRAM, ENROLLMENT KIT 6 (1998).

117. For examples of the wide array of privately-run mutual funds, see Carla Fried et al., *The Money 100 1998: The World’s Best Mutual Funds*, MONEY, June 1998, at 90–98.

118. It is only because the state subsequently exercises its coercive taxing power that it is not protected under the market participant exception. *See infra* Part III.B.

119. Although New York has chosen to offer its Savings Program to citizens of all states, some other states have elected to offer their plans only to state residents. For example, Connecticut, Kentucky, Louisiana, New Jersey, North Carolina, and Vermont are among the states offering college savings programs only to in-state residents. *See Davis, supra* note 12, at 90–92.

120. *Reeves*, 447 U.S. at 440.

121. *See infra* Part III.B.

B. The Market Participant Exception and State Taxation

The Supreme Court will not apply the market participant exception automatically to every case in which a state acts as a market participant. In *New Energy Co. v. Limbach*,¹²² the Supreme Court invalidated an Ohio statute designed to provide certain tax credits against a state-imposed fuel tax. Ohio offered the credit only to ethanol producers in Ohio or to producers in states that afforded similar tax credits to Ohio ethanol producers.¹²³ The Court rejected the market participant exception and held the Ohio statute unconstitutional.¹²⁴ Again drawing the distinction between a subsidy and a tax, the Court held that, although "the tax credit scheme has the purpose and effect of subsidizing a particular industry . . . [t]hat does not transform it into a form of state participation in the free market."¹²⁵ The Court distinguished other cases, including *Hughes*,¹²⁶ holding that taxation is "a primeval governmental activity"¹²⁷ and that the Ohio tax credit "cannot plausibly be analogized to the activity of a private purchaser."¹²⁸ Unlike a bounty, which any private actor may offer, only the state, in its governmental capacity, may offer tax benefits.

The simple fact that a challenged in-state preference is connected with the state's purchase or sale of goods or services does not alone determine that the preference will escape dormant Commerce Clause review.¹²⁹ The market participant cases have established:

a 'virtually *per se* rule' of validity for state discrimination in the marketplace. A *virtually per se* rule, however, need not operate *all* of the time. . . . It follows that, even if a state looks quite like a buyer or seller choosing trading partners, the Court has left itself room not to treat the state as such.¹³⁰

122. 486 U.S. 269 (1988).

123. *See id.* at 271.

124. *See id.* at 277-78.

125. *Id.* at 277.

126. *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794 (1976) (upholding Maryland's bounty on abandoned cars even though the requirements were more burdensome for out-of-state processors).

127. *New Energy*, 486 U.S. at 277.

128. *Id.*

129. *See Coenen, supra* note 98, at 404.

130. *Id.* at 404-05.

Thus, if a state exercises governmental powers that are not available to other private market participants (e.g., the taxing power), it is not exempted from Commerce Clause restrictions.¹³¹

While New York acts as a participant in the investment market by offering the New York Savings Program, it also exercises the sovereign power of taxation. In *Shaper v. Tracy*,¹³² the Ohio Court of Appeals addressed whether a state could offer a tax preference for state-issued bonds without violating the dormant Commerce Clause.¹³³ Ohio offered a state income tax exemption for interest on Ohio-issued bonds but not on bonds issued by other states.¹³⁴ The Ohio court recognized the distinction between a state's participation in a market and the use of its governmental power to tax.¹³⁵ The court explained:

The Commerce Clause is directed at the state's actions as a market regulator; therefore, actions as a market participant are exempt from Commerce Clause analysis. Clearly, when a state chooses to sell bonds and enter into the securities market, it is acting as a market participant. However, when a state chooses to tax its citizens, it is acting as a market regulator.¹³⁶

The *Shaper* court concluded that the market participant exception should not apply to the tax exemption exclusively available for interest on Ohio-issued municipal bonds.¹³⁷ This same distinction applies to the New York tax deduction. By offering a section 529 Plan, New York enters into the investment market and acts as a market participant. Nonetheless, when the state separately applies its taxing power to influence participation in the market, it acts as a market regulator.

The market participant exception to the dormant Commerce Clause is intended to allow a state to function like any other private business when it chooses to conduct business in a particular private market.¹³⁸ When a state then attempts to exercise its sovereign taxing power, however, it no longer acts like any other private

131. See *supra* Part II.B (discussing when a state might legitimately exercise its taxing power in a manner that discriminates against interstate commerce).

132. 647 N.E.2d 550 (Ohio Ct. App. 1994).

133. See *id.* at 551.

134. See *id.*

135. See *id.* at 552.

136. *Id.*

137. See *id.* While the court rejected the market participant defense, it still upheld the preference for Ohio-issued bonds on other grounds. See discussion *supra* Part II.A.

138. See *supra* text accompanying notes 99–100.

business within that market.¹³⁹ A tax will be held unconstitutional if it “favor[s] in-state over out-of-state activities [and] . . . implicate[s] the coercive power of the state.”¹⁴⁰ Because New York exercises its taxing power in relation to the New York Savings Program, it does not act like a private market participant and does not fall within the market participant exception to the dormant Commerce Clause.

C. The New York Savings Program—A “Private-Type” Activity

Although the focus of the Commerce Clause historically has been on state preferences for private businesses,¹⁴¹ its application is appropriate when the state uses its coercive taxing power to favor a private-type activity that is only incidentally run by the state. The factual distinction between New York’s tax preference for the New York Savings Program and the many cases in which state preferences have been invalidated¹⁴² is that the favoritism here is for a state-run program. This factual distinction does not merit different treatment under the dormant Commerce Clause. Even though the New York Savings Program is run by the state, it is similar to hundreds of other private investment plans.

The New York Savings Program is a private-type activity, despite the fact that only a state has the authority to create and offer a section 529 Plan.¹⁴³ Section 529 Plans function like and compete with

139. See *supra* text accompanying notes 128, 136.

140. Walter Hellerstein, *Commerce Clause Restraints on State Tax Incentives*, 82 MINN. L. REV. 413, 424 (1997).

141. A typical formulation of the dormant Commerce Clause restriction on state activity emphasizes governmental regulation of private business such that “[s]tates are barred from discriminating against foreign enterprises competing with local businesses, and from discriminating against commercial activity occurring outside the taxing State.” *Oklahoma Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 197 (1995) (citation omitted); see also *Reeves, Inc. v. Stake*, 447 U.S. 429, 436–37 (1980) (“[T]he Commerce Clause responds principally to state taxes and regulatory measures impeding free private trade in the national marketplace.”); *Attaway*, *supra* note 18, at 761 (“Dormant Commerce Clause opinions repeatedly have emphasized that the focus of the Clause is *private* or *local* trade.”). The Court applies these principles to nonprofit or charitable organizations as well. See *Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine*, 520 U.S. 564 (1997) (holding that an exemption statute which singled out charitable institutions that served mostly state residents for beneficial tax treatment and penalized those institutions that performed principally interstate business violated the dormant Commerce Clause).

142. See *supra* note 16.

143. See 26 U.S.C. § 529(b)(1) (1996) (stating that “[t]he term ‘qualified State tuition program’ means a program established and maintained by a *State or agency or instrumentality thereof*” (emphasis added)).

other private investment vehicles.¹⁴⁴ Even state regulation of non-profit or charitable organizations is subject to Commerce Clause restrictions.¹⁴⁵ The Supreme Court invalidated discriminatory state regulation of a nonprofit organization in Maine, stating that, “[e]ven though [the organization] does not make a profit, it is unquestionably engaged in commerce.”¹⁴⁶ Similarly, the New York Savings Program remains a private-type activity even though the state does not profit from running the Plan.¹⁴⁷

Allowing New York to favor its own section 529 Plan with tax preferences leads to discrimination against out-of-state section 529 Plans and the economic isolation that the Commerce Clause was intended to prevent.¹⁴⁸ Creating a distinction based solely on the state’s involvement in the activity that it then regulates would expand a state’s ability to shield any activity from constitutional scrutiny. In order to protect the underlying goals of the Commerce Clause, a state cannot be free to exercise uniquely governmental powers (e.g., the taxing power) to discriminate against interstate commerce in relation to any activity in which it first chooses to engage.

The underlying rationale of the market participant exception, that states acting as participants in a private market should be treated like other market participants,¹⁴⁹ dictates that state regulation of the New York Savings Program should be subject to the same restraints as regulation imposed on private activity. If a state engaging in private-type activity receives the benefits enjoyed by other private actors, then regulation of that activity should be subject to the same limitations as regulation of those other private

144. Even in the absence of any state tax benefits, an investor is likely to prefer section 529 Plans to private investment plans because of their federal tax benefits but will compare private plans with the section 529 Plans to determine which will result in the greatest return. Section 529 and private plans will compete with each other. For example, if a section 529 Plan performs poorly enough, the tax benefits may not be adequate to make it more attractive than a successful private plan. See *supra* notes 1–4 and accompanying text (explaining section 529 Plans as a means to saving for educational expenses).

145. See *Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine*, 520 U.S. 564, 581–83, 595 (1997) (invalidating a Maine property tax exemption offered to charitable organizations because the exemption applied only to charitable organizations which operated principally for the benefit of in-state residents).

146. *Id.* at 573.

147. See *supra* notes 92, 95 and accompanying text.

148. See *supra* text accompanying notes 22–25.

149. See *Reeves, Inc. v. Stake*, 447 U.S. 429, 437 (1980) (stating that “[t]here is no indication of a constitutional plan to limit the ability of the States themselves to operate freely in the free market”).

actors.¹⁵⁰ Thus, just as the state is not free to establish discriminatory tax incentives favoring in-state private businesses, the state is not free to provide discriminatory tax incentives in favor of the New York Savings Program. State discrimination in favor of that private-type activity should be treated like state discrimination in favor of any other private activity. Therefore, the state tax favoring the in-state section 529 Plan over out-of-state section 529 Plans violates the Commerce Clause and should be held unconstitutional.

CONCLUSION

The New York tax deduction, which provides a state deduction solely for investment in the New York Savings Program, facially discriminates against out-of-state section 529 Plans. This state tax deduction restricts the flow of interstate commerce by discouraging out-of-state investment, contrary to the dormant Commerce Clause's purpose of maintaining free trade among the states. New York's two distinct roles must be recognized: first, it is participating in the private-type activity of offering an investment plan; and second, it is acting as a sovereign to create a tax preference for its in-state private-type section 529 Plan over comparable out-of-state section 529 Plans. Although in its first role New York participates in a "private" investment market, its exercise of its sovereign taxing power takes the state's actions outside of the market participant exception. It is in this second role as a taxing sovereign that New York violates the dormant Commerce Clause.¹⁵¹

Policy arguments favor the maintenance of a competitive environment in which section 529 Plans may operate. Section 529 Plans are not offered in order to raise money for the state sponsors¹⁵² but instead are specifically adopted for the purpose of helping individuals "fund qualified higher education expenses."¹⁵³ Providing investment incentives to help state residents prepare for

150. *See id.* at 439 (reasoning that state proprietary activity should share existing freedoms from constraint enjoyed by private business because "state proprietary activities . . . often are . . . burdened with the same restrictions imposed on private market participants").

151. The first prong of activity alone is acceptable and, if challenged, would likely fall within the market participant exception to dormant Commerce Clause review or within the allowable distribution of state-created benefits. For example, the state could establish a college savings plan and offer it only to state residents. The state's second, independent activity, however, violates the dormant Commerce Clause's prohibition against providing a direct commercial advantage to local business.

152. New York is not permitted "to earn any profit at any time or in any manner from or relating to the Program." NEW YORK PROGRAM BROCHURE, *supra* note 6, at 30.

153. *Id.* at 1.

rising education costs is a legitimate and laudable state goal. States could meet that goal, however, by offering a state tax deduction for investment in *any* section 529 Plan, thus both encouraging investment and avoiding any discrimination against interstate commerce. A competitive market among section 529 Plans, all offering the same tax benefits, will result in more efficiently-run Plans that produce higher returns on investment, thus best achieving the stated purpose of the section 529 Plans.

Although no federal appeals court has yet addressed this question, the issue will inevitably arise as more states adopt section 529 Plans. The state's dual activities—on the one hand, maintaining a private-type investment plan and, on the other hand, separately exercising sovereign taxing powers to favor that in-state investment plan—should not be confused. The first is permissible, but the second is not. Courts should conclude that the state's role in running such a plan prohibits a discriminatory tax deduction favoring its own plan over comparable plans offered by other states. There is no valid interest served by allowing this infringement into a national area of free trade. Courts should uphold the principles of the dormant Commerce Clause and declare the New York tax deduction unconstitutional.