No. 330P11 TENTH DISTRICT

SUPREME COURT OF NORTH CAROLINA

****

DELHAIZE AMERICA, INC.,

Plaintiff,

v.

DAVID W. HOYLE, SECRETARY OF REVENUE OF THE STATE OF NORTH CAROLINA,

Defendant.

From Wake County
COA11-868

****

PROVISIONALLY FILED BRIEF OF AMICUS CURIAE COUNCIL ON STATE TAXATION IN SUPPORT OF PLAINTIFF'S PETITION FOR DISCRETIONARY REVIEW
BEFORE DETERMINATION BY COURT OF APPEALS

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Council On State Taxation, as amicus curiae, files this brief provisionally, as allowed by Appellate Rule 28 (i) in support of the petition for discretionary review filed by the plaintiff in this matter on August 3, 2011.

FACTS

North Carolina law requires each corporation to file an income tax return reporting its own separate income and

deduction items, and does not allow affiliated corporations to file on a combined basis. For decades the defendant exercised its limited statutory power to require corporate taxpayers to file combined income tax returns only under the "most unusual" of circumstances, *Delhaize Am., Inc. v. Lay*, No. 06 CVS 08416, 2011 WL 1679628 (N.C. Super. Jan. 12, 2011) [hereinafter "Op."]. In addition, the general statutes permit corporations filing separately to deduct reasonable payments to their corporate affiliates for services performed. *See* Op. ¶¶ 40–41. Adhering to the statutes and the defendant's consistent application thereof, Delhaize filed a noncombined return, on which it deducted the arm's-length payments that it made to FL Food Lion, Inc. for procurement, private label development, and related services. Op. ¶ 36.

Beginning around 2000, however, the defendant changed course radically and abruptly. *See* Op. ¶ 46. The defendant ordered combined returns with increasing frequency, Op. ¶¶ 49–50, relying on untrained auditors to make ad hoc consolidation decisions often subject to only a single person's review. See Op. ¶¶ 50–51. The defendant refused to answer the business community's requests for guidance, instead deliberately withholding information even from its own auditors, who overwhelmingly expressed their confusion. *See* Op. ¶¶ 50–53.

Delhaize's refund suit and petition arise out of this initiative of the defendant.

REASONS WHY PETITION SHOULD BE GRANTED

COST urges the Court to review this matter before determination by the Court of Appeals because "[t]he subject matter of th[is] appeal has significant public interest . . . .and involves legal principles of major significance to the jurisprudence of the State." N.C. Gen. Stat. § 7A-31(b)(a)(1),(2). This Court should resolve conclusively that Delhaize and other corporate taxpayers have been capriciously subjected to ad hoc tax increases, and that the defendant exceeded its statutory or constitutional authority in an attempt to extract tax revenue that Delhaize could not have known it owed. Failure to resolve this controversy promptly will prolong the substantial uncertainty, thereby threatening the integrity of the tax system and dissuading corporations from doing business in North Carolina.

I. THE COURT SHOULD REVIEW THIS MATTER BECAUSE OF SIGNIFICANT PUBLIC INTEREST

The defendant has assumed near-unfettered power to order corporations such as Delhaize to combine their tax returns, which the Court of Appeals condoned in *Wal-Mart Stores East, Inc. v. Hinton,* 197 N.C. App. 30 (2009), *notice of appeal dismissed as moot*, 363 N.C. 748 (2009). Because of this

precedent, lower courts will uphold the defendant's combination orders unless those orders reflect "a clear manifest abuse of discretion." Op. ¶ 61 (citing *Williams v. Burlington Indus.*, 318 N.C. 441, 446 (1986)).

This Court's immediate intervention is necessary to determine the outer limits of the defendant's power. The Court of Appeals is not permitted to reverse its *Wal-Mart* decision. *In the Matter of the Appeal from Civil Penalty*, 324 N.C. 373, 384 (1989), and in any event, only this Court can provide taxpayers with a definitive construction of N.C. Gen. Stat. § 105-130.6 and North Carolina's Constitution. This Court's refusal to grant discretionary review would therefore do more than leave petitioner's case unresolved: it would signal that in North Carolina, the uncertainty currently plaguing the business community is deemed not to be of "significant public interest . . . ." N.C. Gen. Stat. § 7A-31(b)(a)(1). The public, however, is presently affected as discussed below.

II. STANDARDLESS TAXATION IS ANATHEMA TO A FAIR AND EFFECTIVE TAX JURISPRUDENCE.

The issues of this appeal are important to the jurisprudence of the state because they raise the question whether a governmental agency like the defendant can arbitrarily create the rules of the road as it goes along and require the public to follow.

North Carolina's system of income taxation depends heavily on taxpayer-enforced compliance. It is impossible for the State to audit every corporation's return. *See* A. Mitchell Polinsky & Steven Shavell, *The Economic Theory of Public Enforcement of Law* 42 (Nat'l Bureau of Econ. Research, Working Paper No. 6993, (1999)). Taxation is consequently most effective, in the long term, when citizens are able to determine their tax obligations and are willing to meet those obligations voluntarily, based on clear rules. *See* Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1784 (2000).

But taxpayers have little incentive to file an accurate tax return if the defendant can arbitrarily change the tax rules and alter their tax burdens after they file, in ways the taxpayers never could have reported themselves on their initial returns. In such circumstances, taxpayers may try only to avoid mistakes so egregious that they would warrant penalties. Not only is such a situation unhealthy for proper tax collection, it is patently unfair to taxpayers. "Fairness," moreover, "is indispensible to enacting tax legislation because it increases taxpayer morale and enhances voluntary compliance." Leo P. Martinez, *The Trouble with Taxes: Fairness, Tax Policy, and the Constitution*, 31 HASTINGS CONST. L.Q. 413, 416 (2004); *see also* Posner, *supra*, at 1784 ("People are more likely to pay taxes if tax authorities seem fair and have fair procedures").

Where, as here, auditors can reject corporations' separate returns filed in accordance with the statutes on grounds not communicated to the public, taxpayers are denied an opportunity to file accurately (because, e.g., tax policies are secret) and are vulnerable unless they guess correctly what an unpredictable auditor will require. And where an agency hides decision-making standards even from its auditors, as defendant has done, the resulting confusion will undermine horizontal equity: a cornerstone of tax fairness that requires "equal treatment of [taxpayers] in equal positions." Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354, 355 (1993).

The defendant's treatment of Petitioner is unbefitting a government obliged to provide its citizens with due process of law. The Business Court described the goals of E. Norris Tolson, who became Secretary of Revenue in 2001, as making "the Department . . . act more like a business and less like a government agency with regard to accounts receivable." Op. ¶ 47. High-ranking department officials similarly feared that formulating and disclosing standards might enable taxpayers to challenge defendant's decisions, *see* Op. ¶¶ 50, 53–54; instead, it "worked actively to conceal the standards its decision makers were using" and "forced taxpayers to guess whether they would be subjected to compelled combination and resulting penalties," Op. ¶ 58. Rather than publish standards that would allow taxpayers

to understand what they owed and why, the defendant blind-sided them with vastly increased tax assessments and penalties based on the subjective "decision" of a single tax official whose only apparent guiding principle was increasing revenue for the budget in tight budget years. Transparency is the hallmark of accountability; with regard to combination, transparency was nowhere to be found.

III. STANDARDLESS TAXATION THREATENS THE VIABILITY OF NORTH CAROLINA CORPORATIONS AND FRUSTRATES THE GOALS OF SECURITIES REGULATION.

The defendant's practice of exercising unfettered discretion over corporate taxation threatens the financial security of numerous corporations that do business in North Carolina. The defendant issued combination orders to roughly 100 corporations following its change of policy. Whether a corporation, such as Delhaize, owes over $20.5 million dollars to the defendant affects that corporation's profitability, and perhaps whether it is a worthwhile investment. This downward pressure on valuation may be too much for a taxpayer to bear; corporations may settle and did settle with the defendant rather than litigate even their most meritorious claims.

Uncertainty has the further effect of frustrating accurate and transparent financial disclosures - values at the heart of federal securities law. A company that cannot accurately predict

its state income tax liability, even internally, can scarcely be expected to provide meaningful information to investors.

This problem is made more significant by the recent tightening of financial disclosure requirements. In 2006, the Financial Accounting Standards Board ("FASB") clarified the disclosure requirements surrounding uncertain income tax positions. *See* Fin. Accounting Standards Bd., Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 (2006) [hereinafter "FIN 48"].[1] FIN 48 provides uniform criteria for the preparation of financial statements and expands the required disclosure regarding uncertainty in income taxes. It mandates a reserve for 100% of tax items unless it is "more likely than not" that the company would prevail on those items if they were litigated. This reserve can continue for several years, with interest and other adjustments accruing annually.

Because the defendant's secretive approach to tax assessment leaves companies uncertain as to their tax liabilities, it threatens to skew how companies must allocate their assets, and will frustrate their ability to operate

[1] The Securities and Exchange Commission recognizes as authoritative the financial accounting standards promulgated by the FASB. *See* Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Exchange Act Release Nos. 33-8221, 34-47743, IC-26028, FR-70, 80 S.E.C. Docket 139 (Apr. 25, 2003), *available at* http://www.sec.gov/rules/policy/33-8221.htm.

competitively by making optimal use of their capital. It also makes it difficult, if not impossible, for companies to formulate adequate disclosures to their investors because the company itself cannot be certain whether it will be subject to combined tax liability. Because standardless taxation inhibits disclosure of reliable, concrete information to present and potential investors, it frustrates the goals of securities law.

IV. STANDARDLESS TAXATION DISSUADES CORPORATIONS FROM DOING BUSINESS IN NORTH CAROLINA.

The defendant's approach to forced combination will deter businesses from entering North Carolina unless their interests are protected by this Court. Absent this Court's recognition of statutory and constitutional limitations on the defendant's power, whether tax burdens are fair and predictable will vary without rational explanation. Investment in North Carolina will be discouraged in at least two ways.

First, standardless taxation increases compliance costs. Prior to the defendant's policy change, the fact that business was transacted with affiliates at arm's-length prices all but assured that the defendant would not require corporations to combine their returns. Now, corporations operate in an environment of uncertainty, where even the most standard intercompany transaction can lead to forced combination, which raises the cost of doing business in North Carolina.

Second, the defendant appears to have selectively exercised its combination authority to raise revenue rather than to cause taxpayers to report properly. Every one of the nearly 100 combinations required by the department resulted in an increased tax burden on the relevant taxpayer. Op. ¶ 83. But the defendant did not simply require combination of businesses to determine their "true earnings." It instead *selectively* required combination in this case, requiring Delhaize to combine its return with only one of its two Florida affiliates, *see* Op. ¶¶ 12, 33, 38: including the other affiliate would decrease, rather than increase Delhaize's tax burden. Such a policy is plainly hostile to business interests and principles of fair taxation.

A company deciding whether to expand its operations in a multistate fashion will necessarily consider whether the additional cost and complexity of tax compliance in a state outweighs the business benefits of expansion. At the margin, the uncertainty caused by standardless, effectively unreviewable, tax assessment, like that imposed on Delhaize, could tend to cause companies to (a) generally choose business activities that are of lesser value to the business, society, and the economy, and (b) choose to avoid North Carolina. Such choices, inherent in any system that requires taxation, are made with increasing frequency as the costs of compliance increase.

CONCLUSION

The decision of the Business Court, based on the unreviewed decision of the Court of Appeals in *Wal-Mart*, threatens continued substantial and adverse effects on corporations transacting or considering transacting business in North Carolina. Delayed resolution of the issues raised by this petition will prove costly to North Carolina businesses—and the consumers, employees, and investors that rely on them. To prevent these costs, and to preserve the integrity of North Carolina's tax system, this Court should resolve Plaintiff's case expeditiously and grant its Petition for Discretionary Review Before Determination by Court of Appeals.

This the 12th day of August, 2011.

Alston & Bird LLP

By: _____

Jasper L. Cummings, Jr.
Counsel for Amicus Council On State Taxation
Alston & Bird LLP, 4721 Emperor Blvd., Suite 400, Durham, N.C. 27703-8580
919 862-2302
Fax 919 862-2260
jack.cummings@alston.com
NC Bar No. 1046

CERTIFICATE OF SERVICE

The undersigned hereby certifies that he served a copy of the foregoing PROVISIONALLY FILED BRIEF on the parties by electronic delivery to the email addresses below, this 12th day of August 2011, addressed as follows:

Attorney for Defendant:

Kay Linn Miller Hobart, N.C. Attorney General, P.O. Box 629, Raleigh, NC 27602
khobart@ncdoj.gov

Attorneys for Plaintiff:

James G. Exum, SMITH MOORE LEATHERWOOD LLP, P.O. Box 21927, Greensboro, NC 27420
jim.exum@smithmoorelaw.com

Reid L. Phillips, BROOKS PIERCE MCLENDON HUMPHREY & LEONARD, P.O. Box 26000, Greensboro, NC 27420
rphillips@brookspierce.com

Richard L. Wyatt, Jr., HUNTON & WILLIAMS, L.L.P., 2200 Pennsylvania Avenue, NW, Washington, DC 20037
rwyatt@hunton.com

This the 12th day of August, 2011.

_____

Jasper L. Cummings, Jr
Counsel for Amicus Council On State Taxation:
Alston & Bird LLP, 4721 Emperor Blvd., Suite 400, Durham, N.C. 27703-8580
919 862-2302
Fax 919 862-2260
jack.cummings@alston.com

NC Bar No. 1046