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North Carolina Court Strikes Down 25% Penalty for Failure to File Combined Return

On January 12, 2011, the North Carolina Superior Court held that the imposition of a 25% penalty for failure to file a combined return, lacked adequate procedural due process and violated the North Carolina Constitution.¹ The court began its opinion noting “this case demonstrates what happens when creative accounting meets creative revenue enforcement.” The court went on to hold that, under the Court of Appeals holding in *Wal-Mart Stores East, Inc. v. Hinton*, the North Carolina Department of Revenue (Department) could require a combined return where the taxpayer’s return does not disclose true earnings in North Carolina² but the Department could not impose a 25% penalty on Delhaize.

I. Background

North Carolina has historically required taxpayers to file separate income tax returns for affiliated corporations.³ In the 1990s, in response to a number of tax-motivated corporate restructurings, the Department adopted a policy of requiring some taxpayers to file combined income tax returns. The Department did not, however, provide taxpayers with any guidance regarding when they would be required to file a combined return.

In 1998, Delhaize created an affiliated corporation in Florida, in part to lower its North Carolina tax liability. The Department audited Delhaize’s North Carolina corporate income tax return for the 2000 tax year and concluded Delhaize and its affiliates should have filed a combined income tax return to reflect Delhaize’s “true net earnings” in North Carolina.⁴ Despite Delhaize’s argument to the contrary, the Department found that the restructuring served no visible purpose, other than reducing Delhaize’s state income tax liability. Delhaize paid the assessment, interest and penalties and filed a claim for refund with the Department. The Department denied the refund and Delhaize filed suit in Superior Court.

II. The Court Upholds the Department’s Decision to Require Delhaize to File a Combined Return, But Prohibits the Department from Imposing a 25% Penalty

Following the Court of Appeals’ decision in *Wal-Mart*, the court sustained the Department’s decision to require Delhaize to file a combined return. However, the court held that the imposition of the 25% penalty violated the Due Process Clause of the United States Constitution and the Power of Taxation Clause of the North Carolina Constitution.

A. The Department is Permitted to Require a Combined Income Tax Return

The court first evaluated Delhaize’s claim that forced combination violated its federal substantive due process rights. With limited discussion, the court held that *Wal-Mart* foreclosed Delhaize’s arguments that the Department’s actions were arbitrary or unreasoned because the court found no evidence that would

¹ *Delhaize America, Inc. v. Lay*, 06 CVS 08416 (Jan. 12, 2011).

² *Wal-Mart Stores East, Inc. v. Hinton*, 197 N.C. App. 30, 50; 676 S.E.2d 634, 649 (2009).

³ N.C. Gen. Stat. § 105-130.6.

⁴ *Delhaize* at 12.

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overcome the Department's presumption of good faith requiring combination. The court further stated that it was bound by the Court of Appeals' decision in *Wal-Mart* and that the Department's determination was not clearly erroneous.

Sutherland Observation: Although the court made great strides toward taxpayer fairness with regard to standards for combined reporting, whether these same standards will apply if taxpayers are the beneficiaries of a combined return remains unseen. If combination is required to reflect the taxpayer's "true net earnings," it is unclear whether taxpayers may rely upon *Wal-Mart* and *Delhaize* for the proposition that the Department will permit combination where doing so would result in less tax owed to North Carolina.

B. The 25% Penalty Violated Federal Due Process

Despite upholding the Department's ability to forcibly combine Delhaize, the court held that the Department abused its discretion when it ordered Delhaize to pay a 25% penalty because forced combination was "contrary to established law."⁵ In *Wal-Mart*, the taxpayer conceded the validity of the automatic 25% penalty provided that the forced combination was lawful. The court in *Wal-Mart* did not address the arguments raised by Delhaize in the current case.⁶

The court did not find Delhaize's restructuring without fault. The court rejected Delhaize's position that it implemented the tax restructuring at the same time as an overall corporate restructuring with real business purposes, holding that Delhaize's tax restructuring was solely tax motivated. Additionally, the court noted that in Delhaize "having paid close to \$2 million to provide a restructuring plan with significant tax savings, Cooper's [(Delhaize's tax adviser at the time)] setting the rates for intercompany services [wa]s problematic." However, the Department did not choose to attack this allocation based on conflict or impropriety in assessing the penalties.

The court observed that North Carolina's General Assembly had amended N.C. Gen. Stat. § 105-236 to prohibit the Secretary of the Department from assessing a 25% penalty for failure to file a combined return unless the Secretary adopted permanent rules that clearly delineated the grounds under which the Secretary will order a combined return. Finding the amendments to N.C. Gen. Stat. § 105-236 to be evidence that the General Assembly recognized the "inherent inequality in the Department's use of the automatic 25 percent penalty," the court proceeded to evaluate Delhaize's constitutional claims.

Although the court did not find that the imposition of the 25% penalty violated *substantive* due process rights, the court stated that the assessment raised *procedural* due process concerns. Reasoning that payments to the government are property interests that cannot be deprived before notice and an opportunity to be heard, the penalty's automatic imposition without a finding of negligence or improper behavior violated procedural due process. The court reasoned that taxpayers faced an automatic 25% penalty if they were forced to file a combined income tax return, even though they paid the tax owed and despite the fact that there were no guidelines regarding when a combined return would be required. Essentially, taxpayers received a penalty for obeying the law.

⁵ *Delhaize* at 23.

⁶ The court in *Wal-Mart* permitted the 25 percent penalty because the taxpayer failed to raise the issue that the penalty was invoked without a finding of negligence. Specifically, in *Wal-Mart*, the plaintiff challenged the penalty primarily based on the unlawfulness of the forced combination. In this case, Delhaize is challenging the penalty based upon due process.

In holding the penalty unconstitutional, the court focused on the Department's purposeful failure to issue guidance. Specifically, the court pointed out the Department's internal correspondence as classifying taxpayers and their advisors as "the dreaded Jung [sic] Hoard [sic] (also know [sic] as [taxpayers] and their representatives)...." The court found that the Department "actively worked to conceal the standards its decision makers were using to exercise their authority to combine returns." Additionally, the court discussed the Department's failure to provide guidance to its own auditors. "When guidance from the secretary is so elusive that the Department's own auditors do not know the conditions that will give rise to a twenty-five percent (25) penalty, and when decisions about the imposition of the penalty are made by a guarded coterie applying unpublished criteria, who appear to revel in the criteria's mystery, the ordinary taxpayers 'exercising ordinary common sense' cannot sufficiently understand or predict when a penalty will be assessed."

The court concluded that the Department's assessment of the 25% penalty against Delhaize was "an arbitrary and abusive exercise of power that serves mainly to coerce taxpayers into submitting to its will. The club of the twenty-five (25%) penalty was deftly employed by the Department when it created the amnesty program pursuant to which it agreed to put down the club if taxpayers reached an agreement to pay the additional tax calculated using the combined return."⁷

Sutherland Observation: Few lawsuits successfully have challenged the retroactive imposition of strict liability penalties. The court's holding may serve as a cautionary note to other states that seek short-term revenue by authorizing amnesty programs with strict liability penalties imposed on taxpayers that are eligible but decline to participate.

C. The 25% Penalty Violated the Power of Taxation Clause of the North Carolina Constitution

The court next considered whether the 25% penalty violated the Power of Taxation Clause of the North Carolina Constitution. Finding in the affirmative, the court reasoned that the Department treated taxpayers unequally without rationale. The court observed that a finding of negligence was necessary to apply a 10% penalty to taxpayers with less than a 25% variance between their separate and combined returns, but no negligence finding would be possible because corporations could not elect to combine voluntarily. Thus, no penalty could be assessed on taxpayers with less than a 25% variance.

The court went on to hold that the Department did not exercise the power of taxation in a "just and equitable manner." "Even though the rule of equality permits many 'practical inequalities,' [citation omitted], this particular disparity in tax treatment is without a rational basis. [citations omitted]. The disparity is unnecessary and unjust. It is a violation of Article V, Section 2(1) of the North Carolina Constitution."⁸

⁷ *Delhaize* at 30.

⁸ *Id* at 33.

Sutherland Observation: Taxpayers that were subject to the 25% penalty, but that have not litigated the issue, may have an opportunity to seek a refund. Taxpayers should consider this option, as these refunds may be substantial given the size of the penalty.

Additionally, based on the court's holding that the 25% penalty violated the Power of Taxation Clause, the Department may offer additional guidance in the future regarding this issue. We understand that the legislature has begun to address this issue in enacting N.C. Gen Stat. § 105-236(a)(5)f as of July 1, 2010 (stating that if the Department requires a taxpayer to file a combined return, the amount of tax shown on the original return is not considered a deficiency and is not subject to penalties, with certain exceptions under (a)(5)1-3).

III. Conclusion

Although the court was bound by the decision in *Wal-Mart* regarding forced combination, the court held that imposition of the 25% penalty violated both the Federal Due Process Clause of the Fourteenth Amendment and the Power of Taxation Clause under the North Carolina Constitution.



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