

Delhaize Am., Inc. v. Lay, 2011 NCBC 2.

NORTH CAROLINA

WAKE COUNTY

DELHAIZE AMERICA, INC.,

Plaintiff,

v.

KENNETH R. LAY, Secretary of Revenue
of the State of North Carolina,

Defendant.

IN THE GENERAL COURT OF JUSTICE
SUPERIOR COURT DIVISION

06 CVS 08416

ORDER AND OPINION

Overview

{1} This matter comes before the Court on cross-motions for summary judgment and on Defendant's Motion to Dismiss. For the reasons set forth below, each party's summary judgment motion is GRANTED IN PART and DENIED IN PART. Defendant's Motion to Dismiss is DENIED.

{2} This case demonstrates what happens when creative accounting meets creative revenue enforcement. During the late 1990s it became fashionable for large accounting firms to market "restructuring" projects designed to reduce the state income tax of corporations. Many of these restructurings were sham transactions with no substance. *See Wal-Mart Stores East, Inc. v. Hinton*, 197 N.C. App. 30, 676 S.E.2d 634 (2009) (hereinafter "*Wal-Mart*"). In its *Wal-Mart* decision, the Court of Appeals rejected many of the arguments advanced herein by Delhaize America, Inc. ("Plaintiff or Delhaize"). This Court is bound by that decision. However, Delhaize raises new issues not presented in *Wal-Mart*. Subsequent to the *Wal-Mart* decision, the North Carolina General Assembly has amended the

applicable revenue statutes to address the problem the Court finds most troubling in this case.¹

{3} The North Carolina Department of Revenue (“Department of Revenue” or “Department”) responded to the wave of corporate restructurings by changing its policies without providing notice to taxpayers and without providing its staff with guidelines on when to require consolidation among restructured companies. It offered an amnesty program for corporate taxpayers who had restructured operations pursuant to which taxpayers could avoid imposition of the twenty-five percent (25%) penalty if they reached agreement with the Department of Revenue on the tax owed by the taxpayers’ combined operations. The program was so successful that the Department of Revenue collected some \$300 million in revenue at a time when the state’s budget was severely constrained.

{4} As will be discussed more completely below, Delhaize conducted a restructuring during 1998 designed by PricewaterhouseCoopers, LLP (PwC) (then Coopers & Lybrand). After an audit, the Department of Revenue ordered Delhaize to file a combined return and assessed additional tax, interest, and a twenty-five percent (25%) penalty. Delhaize paid the taxes, interest, and penalty and sued for a refund, contesting the Department’s right to order a combined return, its conduct in changing its position without notice and guidelines, and its assessment of the penalty.

{5} The Court finds below that Delhaize raises new issues which warrant a refund of the penalty assessed against it but which do not take it out of the general perimeters of the *Wal-Mart* decision with respect to the Department of Revenue’s ability to order a combined return.

Brooks, Pierce, McLendon, Humphrey & Leonard, LLP by Reid L. Phillips and William G. McNairy; Hunton & Williams, LLP by Richard L. Wyatt, Jr. and Joseph P. Esposito for Plaintiff Delhaize America, Inc.

¹ See N.C. Gen. Stat. §§ 105-130.6, 105-236(a)(5)(f) (Lexis 2010); 2010 N.C. Sess. Laws 31.10(b), (d) (Lexis 2010).

*North Carolina Department of Justice by Kay Linn Miller Hobart and
Michael D. Youth for Defendant Secretary of Revenue.*

Tennille, Judge.

I.

PROCEDURAL BACKGROUND

{6} On December 28, 2007, Plaintiff filed this action in Wake County Superior Court pursuant to Section 105-267 of the North Carolina General Statutes. Plaintiff filed the Notice of Designation simultaneously with the Complaint. This action was designated a mandatory complex business case by Order of the Chief Justice of the Supreme Court of North Carolina dated December 31, 2007, and subsequently assigned to the undersigned Special Superior Court Judge for Complex Business Cases.

{7} On December 15, 2009, Defendant filed its Motion to Dismiss pursuant to Rule 12(b)(6) of the North Carolina Rules of Civil Procedure. On April 20, 2010, Plaintiff and Defendant filed cross-motions for summary judgment. The Court heard oral argument on Defendant's Motion to Dismiss and on the parties' motions for summary judgment on July 1, 2010.

II.

FACTS

A.

THE PARTIES

{8} Plaintiff Delhaize is a corporation organized under the laws of the State of North Carolina, having its principal place of business in Salisbury, North Carolina. Plaintiff was formerly known as Food Lion, Inc. but changed its name to Delhaize America, Inc. on September 9, 1999. (Second Am. Compl. ¶ 1.)

{9} Defendant Kenneth R. Lay ("Defendant" or the "Secretary") is the North Carolina Secretary of Revenue. He is named as a Defendant solely in his official capacity. The term Defendant is used herein to refer to both current and former

Secretaries of Revenue of the State of North Carolina in their official capacities. (Second Am. Compl. ¶ 2; Answer to Second Am. Compl. (“Answer”) ¶ 2.)

B.

FOOD LION’S CORPORATE STRUCTURE

{10} In 1992, Food Lion, Inc. (“Food Lion”) operated as a single, stand-alone entity. (Second Am. Compl. ¶ 51.) It recently had completed a major expansion into the southwestern United States, an area outside its traditional geographic market. (Pl. Delhaize America, Inc.’s Mem. in Supp. of Its Mot. for Summ. J. (“Pl.’s Summ. J. Br.” 5.)

{11} On November 5, 1992, a broadcast aired on ABC’s “PrimeTime Live” alleging that Food Lion stores were selling rotten meat and spoiled dairy products to customers. (Pl.’s Summ. J. Br. 4.) At the same time, Food Lion was experiencing significant competition from other large, low-cost grocery providers, like Wal-Mart. (Rule 30(b)(6) Dep. of R. William McCanless (“McCanless Dep.”) at 26:1–29:11.) After the broadcast, Food Lion stores in the Southwest and Florida performed poorly. (Food Lion, Inc. Mins. of the Meeting of the Board of Directors (“Bd. Meeting Mins.”) Sept. 10–11, 1997 at 4.) The company’s profits fell from \$178 million in 1992 to \$3.8 million in 1993. (Pl.’s Summ. J. Br. 5.) Eventually, the company withdrew entirely from the Southwest. (Pl.’s Summ. J. Br. 5.)

{12} With the Food Lion brand tarnished and the grocery industry demanding consolidation, management decided to grow the company by acquiring other grocery chains which would retain their own brands and identities. (McCanless Dep. at 26:1–29:11, 39:2–14.) Food Lion also formulated a plan to restructure itself in a way that would accommodate the growth. Beginning in 1996 and continuing through November 2004, Plaintiff underwent a complete corporate restructuring, which transformed it from an operating company into a holding company. (Second Am. Compl. ¶ 48; Pl. Delhaize America, Inc.’s Br. in Opp’n to Def.’s Mot. for Summ. J. (“Pl.’s Resp. Br.”) 5.) To begin the restructuring, Food Lion formed a wholly-owned subsidiary, FLI Holding Corp. (Second Am. Compl. ¶¶ 48, 51.) FLI Holding

Corp. then acquired Kash n' Karry Food Stores, Inc., a corporation operating retail grocery stores primarily in Florida with a reputation for procuring fresh products and with expertise in pharmacy services. (McCanless Dep. at 40:17–41:13; Answer ¶ 52.) In October 1997, Food Lion formed FL Food Lion, Inc. (“FLFL”), a Florida corporation, also housed under FLI Holding Corp. (Second Am. Compl. ¶ 54.) Thereafter, Plaintiff continued to make acquisitions of other grocery chains in the eastern United States. (Second Am. Compl. ¶¶ 65–70.)

{13} On August 17, 1999, Food Lion called a special shareholders’ meeting to vote on two proposals. The first would convert Food Lion into a holding company by transferring substantially all of its assets and operations into a newly formed, wholly-owned subsidiary. The second would change the name of the corporation from “Food Lion, Inc.” to “Delhaize America, Inc.” (Second Am. Compl. ¶ 67.) Shareholders approved both the restructuring plan and the name change on September 7, 1999. (Second Am. Compl. ¶ 67.) There is no dispute that the changes described above were strategic business decisions.

C.

FOOD LION’S TAX REDUCTION PLAN

{14} Coopers & Lybrand (“Coopers”) was Food Lion’s external auditor in 1996 and 1997. (Def.’s Summ. J. Br. 6 n.5.) After Coopers conducted an annual review of its 1996 audit results for Food Lion, it approached Food Lion with a specific tax reduction plan involving what would become FLFL.² (McCanless Dep. at 172:20–173:24; Dep. of Laura C. Kendall (“Kendall Dep.”) at 18:4–23.) Accountants at Coopers sought out Ms. Laura Kendall, Food Lion’s Vice President of Finance and Chief Financial Officer in 1997, and they told her there was an opportunity within Food Lion’s overall restructuring plan to reduce its North Carolina tax

² As the facts surrounding this dispute pre-date the passage of Sarbanes-Oxley, Coopers was not prohibited from serving as Food Lion’s external auditor and as a vendor selling tax reduction strategies. At the time, Coopers and other accounting firms were selling tax reduction strategies that involved the creation of holding companies. (McCanless Dep. at 147:12–148:12.)

obligation. (McCanless Dep. at 172:7–173:25.) Coopers called this plan the “Vision Project.” (McCanless Dep. at 142:1–9.)

{15} During a presentation to Food Lion executives, Coopers proposed creating interrelated companies to shift income from high tax jurisdictions to low or no tax jurisdictions. (*See* Def.’s Dep. Ex. 12: Coopers & Lybrand’s Business Solutions Presentation.) The strategy relied on three elements: (1) Food Lion transferring assets (including intellectual property and employees working in North Carolina) to a related non-North Carolina company; (2) Food Lion paying fees and royalties to the related company for its use of the assets, which would create a tax deduction in North Carolina; and (3) the non-North Carolina company returning cash to Food Lion in the form of tax-free dividends. (Def.’s Summ. J. Br. 7.) The transfer would result in no reciprocal increase in income tax because the non-North Carolina company would be incorporated in a combined reporting state, and intercompany payments are eliminated in the calculation of income in those states. (*See* Def.’s Dep. Ex. 12: Coopers & Lybrand’s Business Solutions Presentation.)

{16} In July 1997, Coopers estimated that under the plan, Food Lion’s annual North Carolina income tax liability would be reduced by \$9,579,848. (Def.’s Summ. J. Br., Ex. A8.) Food Lion could save between \$60 million and \$75 million in North Carolina tax obligations over a five-year period. (Def.’s Summ. J. Br., Ex. A5; Letter from William Coe, Coopers & Lybrand, to Laura Kendall (March 11, 1998).) Coopers’ initial fee for implementing the Vision Project was \$1.8 million. (Letter from Keith Cunningham to Bill McCanless (May 11, 2000).)

{17} At the September 1997 Meeting of the Food Lion Board of Directors, Ms. Kendall presented the Vision Project to the Board in a document entitled “State Tax Planning Project.” (Bd. Meeting Mins. Sept. 10–11, 1997 at 10.) At the December Board Meeting, the Food Lion Board of Directors approved the Vision Project and agreed to retain Coopers to implement it. (Bd. Meeting Mins. Dec. 1, 1997 at 9–11.)

{18} After Food Lion created FLFL, it transferred assets to FLFL according to the Vision Project plan. Those assets included: the ownership and operation of Food Lion stores located in Florida; all Food Lion employees in Florida; certain employees

located in Salisbury, North Carolina who had previously provided national brand procurement and private label development, design, and procurement services to Food Lion; certain of Food Lion's national brand procurement and private label product development, design, and procurement services; and its rights and interest in its private label trademarks and the Food Lion name and logo. (Second Am. Compl. ¶ 55; Delhaize America, Inc. Auditor's Report 1998–2000 (“Auditor's Report”) at 1–3.)

{19} After the transfer, FLFL provided procurement services and private label development services for Food Lion, Kash n' Karry, and FLFL's retail stores. Its duties included: identifying and determining the mix of products offered for sale at the stores, maintaining relationships with third party vendors, determining the quantities of inventory, securing favorable prices, arranging for deliveries of product, negotiating advertising arrangements, and consulting with Food Lion's advertising and marketing personnel on product placement. (Auditor's Report at 2.)

{20} FLFL also owned all trademarks, trade names, and service marks used by both Food Lion and FLFL. (Auditor's Report at 2.) As owner of those intellectual property rights, it was charged with identifying products to market under the Food Lion trademarks, maintaining relationships and negotiating prices with vendors, ensuring quality, assisting in the packaging design and marketing initiatives, and protecting and defending the marks and other intangibles that it owned. (Auditor's Report at 2.)

{21} Food Lion retained Coopers to perform an Intercompany Pricing Study to determine the proper amount that FLFL should charge its corporate grandparent for its procurement functions, its private label development services, and the licensing of Food Lion's marks and trade names. (Second Am. Compl. ¶ 61.) Coopers evaluated prices charged by other companies for comparable services. (Coopers & Lybrand Inter-Company Pricing Study (“Pricing Study”) 4.) It provided Food Lion with a range of fees for national brand procurement services and private label development services that it believed complied with the arm's length standard. (Pricing Study 98–110.) FLFL charged Plaintiff fees for its services that were

within those ranges (a national brand procurement fee equal to 1.25% of national brand sales and a private label development fee equal to 11% of private label sales). (Pl.'s Summ. J. Br. 8 n.27; Rule 30(b)(6) Dep. of Lewis Odell Campbell, Jr., FLFL Vice President Center Store Merchandising ("Campbell Dep.") at 175:5–23; McCanless Dep. at 305:2–17.) Having been paid close to \$2 million to provide a restructuring plan with significant tax savings, Coopers' conflict of interest in then setting the rates for intercompany services is problematic. However, the Department did not choose to attack the allocation based on any conflict theory or the impropriety of the allocation as it could have done. *See* N.C. Gen. Stat. § 105-130.16.

{22} When the Vision Project was implemented, private label employees and procurement and category management employees who were "transferred" to FLFL performed the same services for FLFL that they previously had performed for Food Lion, and they worked in the same location in which they always had worked, Salisbury, North Carolina. (Campbell Dep. at 35:15–36:6.) True to the plan, FLFL charged Food Lion fees for those private label and procurement services. (Def.'s Summ. J. Br. 17, 29.) It also paid for the right to use the trademarks and trade names it owned prior to FLFL's creation. (Auditor's Report at 8.)

{23} The cash flow between the entities was circular. All the royalties and fees that Food Lion paid to FLFL came back to Food Lion in the form of tax-free dividends. (*See* Aff. of Donna Powell, Assistant Director of the Corporate, Excise and Insurance Tax Division of the N.C. Dep. of Rev. 2004-2010 (Apr. 20, 2010) ("Powell Aff.") ¶ 11(a).) All cash at FLFL and Food Lion's other subsidiaries was transferred to Food Lion on a nightly basis. (Letter from Charles B. Neely, Jr., Counsel, to Mr. Gregory Radford, Director Corporate, Excise and Insurance Tax Division of the N.C. Dep. of Rev. ("Neely Letter") (Sept. 26, 2005), Ex. A at 6; Dep. of Keith Alan Cunningham ("Cunningham Dep.") at 14:1–21.) Intercompany transactions were recorded by journal entries. (Cunningham Dep. at 14:17–19.) Thus, the actual payments Food Lion made to FLFL for its services and the

dividend payments FLFL made to Food Lion had no impact on Food Lion's actual cash flow.

{24} Ultimately, the plan resulted in income distortions between Food Lion and FLFL and a decline in Food Lion's profitability. (*Cf.* Ex. 6A and Ex. 6B of Def.'s Rebuttal Report of Ednaldo Silva, Ph.D. (as amended Apr. 10, 2010).)

D.

FOOD LION'S RATIONALE

{25} When Plaintiff evaluated whether to implement the Vision Project as part of its broader restructuring effort, it considered only the tax benefit it could receive from its implementation.

{26} At the September 1997 Meeting of the Board of Directors, Ms. Kendall called the Vision Project a "State Tax Planning Proposal" that was designed to reduce the company's state tax liability through the creation of an indirect subsidiary to hold certain assets of the company. (Bd. Meeting Mins. Sept. 10-11, 1997 at 10.) When comparing the cost versus the benefit of making the change, Ms. Kendall only compared the potential tax benefits of the plan with Coopers' fee for implementation. (Bd. Meeting Mins. Sept. 10-11, 1997 at 10.) She did not consider any costs or benefits of operational changes. Food Lion admitted that it had done "no formal analysis or cost benefit study quantifying the economic benefit" of the plan. (Neely Letter, Ex. A at 5.)

{27} In a memorandum to Plaintiff's Board of Directors dated November 5, 1997, Ms. Kendall called the Vision Project a "State Tax Planning Project" that was "designed to accomplish certain corporate objectives, including the reduction of Food Lion's state income tax liability." (Letter from Laura Kendall to the Board of Directors (Nov. 5, 1997).) Though "certain corporate objectives" could include benefits other than tax reduction, Ms. Kendall stated that the plan "is intended to have little or no impact on the day to day operations of the company." (Letter from Laura Kendall to the Board of Directors (Nov. 5, 1997).)

{28} In a memorandum to senior company officials dated November 6, 1997, called “Tax Project Talking Points,” Food Lion was prepared to state that the project was being implemented “solely for internal corporate purposes” and it was “designed to have no impact on Food Lion operations.” (Mem. from Chris Ahearn to Kristina Schillinger (Nov. 6, 1997).) Further, it was designed to have no impact on employees. All employees’ reporting structures would remain the same as they existed at that time, and the “project [would] have no impact on employees’ status or positions in the company.” (Mem. from Chris Ahearn to Kristina Schillinger (Nov. 6, 1997).)

{29} During discovery, Food Lion acknowledged that it never “specifically [] quantified” the effect the FLFL reorganization had on profits unrelated to tax benefits. (Food Lion’s Responses to the Secretary’s Request for Production of Documents at 11 ¶ 2.) Bill McCanless, Plaintiff’s Senior Vice President, Chief Administrative Officer, and Secretary in 1998 and later President and Chief Financial Officer, speaking for senior management, said in his deposition, “[the Vision Project] never registered as it was some type of project or component of our corporate strategy [It] is better described as it’s the tax advice” (McCanless Dep. at 64:23–24.)

{30} Even Coopers, the architect of the Vision Project, understood that as conceived, its intended benefit was tax savings. As part of the Vision Project, Coopers billed Food Lion to determine a business purpose for the new structure. (Letter from William Coe to Laura Kendall (Mar. 11, 1998), Enclosure.)

{31} Food Lion’s decision to create FLFL was not based on operations. (Bd. Meeting Mins. Sept. 10–11, 1997 at 10; Bd. Meeting Mins. Dec. 1, 1997 at 8–11; McCanless Dep. at 186:5–22.)

{32} In fact, “the tax planning in and of itself” never had any impact on the day-to-day operations of the company. (McCanless Dep. at 137:10–17.) After the transfer, there were no changes in either the functions or the day-to-day operations of private label employees and procurement employees. (Campbell Dep. at 37:14–19, 40:6–41:16.)

{33} Mr. McCanless later stated in an affidavit that housing Plaintiff's procurement functions under one company would be of value to both Kash n' Karry and Food Lion. (Aff. of Ross William McCanless ("McCanless Aff.") (May 11, 2010) ¶¶ 29, 30.) First, he stated that Kash n' Karry had expertise in fresh products procurement, and Food Lion provided expertise in other products that could be valuable to Kash n' Karry. (McCanless Aff. ¶ 29.) Second, he stated that the new structure could give Food Lion protection from attacks from unionized grocery chains they might later acquire. (McCanless Aff. ¶ 30.) Third, he stated that housing the procurement function in a separate entity would assure potential acquisition targets that their grocery stores would not be converted to "cookie cutter" Food Lion stores, thereby increasing the likelihood that owners would sell to Plaintiff. (McCanless Dep. at 30:15–32:23.) Finally, he stated that Food Lion put a leadership team in place that would be responsible for both chains and could provide services to new acquisitions. (McCanless Aff. ¶ 29.)

{34} The record is clear that Food Lion implemented the Vision Project for state tax savings. This newly discovered "value" does not change that fact. Additionally, the "new" leadership team Mr. McCanless referenced remained in Salisbury doing the same job they had always been doing at Food Lion. (McCanless Dep. at 35:15–37:13.) There is no evidence that these employees working for FLFL added more value to the organization than they could have as Food Lion employees. Nor did the company try to quantify the benefits the Vision Project would have on the company in addition to tax savings.

{35} The only significant effect the Vision Project had on Delhaize was a substantial reduction in its North Carolina state income tax obligation. This part of Food Lion's restructuring effort lacked economic substance.

E.

2000 TAX RETURN

{36} Delhaize filed a North Carolina corporation tax return for the tax year ending December 31, 2000, in which it reported a total income of \$2,565,741,505.

(Answer ¶ 10; 2000 Tax Return of Delhaize America, Inc. (“2000 Return”) at 2.) From its total income, it deducted \$2,258,280,069, for a taxable income of \$307,461,436. (2000 Return at 2.) To calculate its North Carolina tax obligation, Delhaize added \$5,273,655 for a total income of \$312,735,091. (2000 Return at 3.) From that amount, it deducted \$273,982,913 for the dividends FLI Holding Corp. paid to Delhaize. (2000 Return at 2; Neely Letter, Ex. A at 3.) FLI Holding Corp. received the same amount in dividends from FLFL. (Neely Letter, Ex. A at 7.) This amount consisted of \$162,145,316 in private label fees and \$93,908,559 in procurement fees. (Neely Letter, Ex. B at 3.) Additionally, Delhaize claimed a tax credit under Article 3A of Chapter 105 of the North Carolina statutes for creating new jobs in North Carolina for some employees in Salisbury that were identified as FLFL employees. (Powell Aff. at ¶¶ 12–18.)

{37} FLFL also filed a corporation tax return for the tax year ending December 31, 2000. It paid North Carolina income taxes in North Carolina in the amount of \$2,824,609.³ (Second Am. Compl. ¶ 11.)

{38} During the period 2002 through 2004, the Department of Revenue conducted an audit of the North Carolina multistate corporation income tax returns filed by Delhaize for the tax year 2000. (Answer ¶ 6.) On September 28, 2004, the Department issued a Notice of Corporate Income Tax Assessment of additional tax, interest, and penalties against Delhaize for tax year 2000. (Second Am. Compl. ¶ 8.) The Audit concluded that the income of Delhaize and FLFL should be combined to reflect Delhaize’s “true net earnings” in North Carolina. (Auditor’s Report at 12.)

{39} On March 20, 2006, Delhaize paid the Department \$4,387,164 in additional income tax for the 2000 tax year, \$1,289,068 in interest, and \$1,188,008 in penalties, and it demanded a refund of the additional income tax, interest, and penalties in writing from the Secretary within the applicable protest period. (Answer ¶ 15.) The Secretary did not refund the additional income tax, interest,

³ Delhaize did not ask the North Carolina Department of Revenue for a Private Letter Ruling to determine whether it would be required to file a consolidated tax return with FLFL for the 2000 tax year before filing its North Carolina Tax Return.

and penalties, and Delhaize has sued Defendant for a refund of the additional amount paid. (Answer ¶ 17.)

F. THE AUDIT

{40} The Department of Revenue publishes its policies, derived from the North Carolina General Statutes, in Technical Bulletins. (Rule 30(b)(6) Dep. of John William Sadoff (“Sadoff Dep.”) (Jan. 26–28, 2010) at 53:8–10.) The Bulletins provide guidance to taxpayers and Department employees. (Dep. of Gregory B. Radford (“Radford Dep.”) (Feb. 2–3, 2010) at 88:10–20.) Since 1964 the Department has stated in its Technical Bulletins that “a taxpayer corporation which is a subsidiary or affiliate of another corporation or group of corporations is required to limit any deductions for payments to, or charges by, its parent or other affiliated corporation to amounts which are reasonable in relation to the goods or services received therefor.” (State of North Carolina Franchise Tax and Corporate Income Tax Bulletins for Taxable Years 1963 and 1964 at 53; State of North Carolina Rules and Bulletins Taxable Years 2007 & 2008.) Mr. Gregory Radford, Director of the Department’s Corporate, Excise and Insurance Tax Division, stated in his deposition that the language from that section of the Technical Bulletin never changed in the eight years he served as director (2001–2009). (Radford Dep. at 86:25–87:5.)

{41} The Department never announced to the taxpaying public that taxpayers would not be permitted to take as a deduction for an otherwise valid business expense a payment to an affiliated corporation that was reasonable in relation to the goods and services received. (Radford Dep. at 89:23–90:4.)

{42} Before and after the 2000 tax year, the Department told taxpayers that affiliated corporations, like Delhaize and FLFL, were prohibited by law from filing consolidated returns unless ordered to do so by the Secretary of Revenue. In the Department’s private letter rulings (unpublished decisions intended for a single taxpayer), the Secretary stated that the Department may order a return covering companies’ consolidated operations if the Secretary finds that the separate reports

do not disclose the “true earnings” of the corporations based on their business conducted in the state. (Pl.’s Summ. J. Br., Ex. 23: Form Letter from Jack Harper, Director Corporate Excise and Insurance Tax Division (Feb. 4, 1997); Ex. 24: Form Letter from Jack Harper and Bobby L. Weaver, Jr., Administrative Officer Corporate, Excise and Insurance Tax Division (Aug. 24, 1999); Ex. 25: N.C. Dep. of Rev. Priv. Ltr. Rul. CPLR 2003-137 (May 13, 2008).)

{43} The Department’s correspondence and private letter rulings dating from the late 1980s to the mid-2000s demonstrate that its policies with respect to the determination of what constitutes “true earnings” have not been consistent. The record indicates that in 1987 and 1989, the Department stated in correspondence to individual corporations and to the North Carolina Attorney General’s Office that they would be allowed to deduct payments to affiliated companies if the payments satisfied the “arm’s length” standard set by federal Internal Revenue Code Section 482, a standard defining “fair compensation.” (Pl.’s Summ. J. Br., Ex. 34: Letter from Helen Powers, Secretary of Revenue to [redacted] (Jan. 23, 1989); Ex. 35: Letter from Larry D. Rogers, Director Corporate Income & Franchise Tax Division, and W.H. Baker, Jr., Supervisor Audit Section, to [redacted] (Jan. 22, 1987); Ex. 36: Mem. from Larry D. Rogers, Director Corporate Income & Franchise Tax Division, to George W. Boylan, Special Deputy Attorney General, Re: Consolidated Returns (G.S. 105-130.6) (Oct. 14, 1987).)

{44} Yet, in a 1987 opinion letter from the Attorney General’s Office to the Department’s Corporate Income and Franchise Tax Division, Newton Pritchett, Assistant Attorney General, laid out a broader standard. Pritchett told the Department: “[U]pon a finding that the corporation’s report does not reflect taxable income attributable to this state, the Secretary may require a consolidated return.” (Attn’y Gen Op. 629 (Oct. 27, 1987).) The letter was in reference to a situation where related companies were diverting income. (Attn’y Gen Op. 629 (Oct. 27, 1987).) There was no reference in the letter to fair value or fair compensation.

{45} There were instances in the 1990s when the department required combination without making a determination on compensation in excess of fair

value, basing the decision instead on a finding of income distortion. (Def.'s Summ. J. Resp. Br. ("Def.'s Resp. Br.") 15.) One private letter ruling from 1997 stated that "the Secretary is not precluded from requiring a combined return even if the dealings are conducted at 'arm's length.'" (Powell Aff. ¶ 22; *see also* Powell Aff., Ex. 30: N.C. Dep. of Rev. Priv. Ltr. Rul. CPLR 97-17 (Oct. 1, 1997).) In 1999, PricewaterhouseCoopers, LLP (PwC) requested a private letter ruling from the Department for two of its corporate clients who were planning to restructure. (Pl.'s Summ. J. Br., Ex. 110: N.C. Dep. of Rev. Priv. Ltr. Rul. CPLR 99-47 (Feb. 18, 1999).) The restructuring would create wholly-owned subsidiaries that would receive intellectual property and other assets previously owned by the parent corporations and that would be licensed back to the parents for a fee consistent with Section 482 of the Internal Revenue Code. (Pl.'s Summ. J. Br., Ex. 110: N.C. Dep. of Rev. Priv. Ltr. Rul. CPLR 99-47 (Feb. 18, 1999).) The Department sent a Private Letter Ruling to PricewaterhouseCoopers, LLP (PwC) in which it stated that the restructuring of two of its clients would not lead to combination if the arrangement did not distort net income attributable to North Carolina. (Pl.'s Summ. J. Br., Ex. 110: N.C. Dep. of Rev. Priv. Ltr. Rul. CPLR 99-47 (Feb. 18, 1999).) There was no mention of fair or reasonable compensation.

{46} Before 2000, consolidations required by the Department were rare. (*See* 30(b)(6) Dep. of Gregory B. Radford (Jan. 28, 2010) at 439:11–17.) One private letter ruling stated that the "it would be a most unusual situation" to require consolidation. (Pl.'s Summ. J. Br., Ex. 38: Letter from Helen Powers, Secretary of Revenue, to [redacted] (May 6, 1968).) Another stated that "it is rare that a consolidated return is required," and a consolidation would not be required merely because it produced more revenue for the State or favorable tax consequences for the taxpayer. (Pl.'s Summ. J. Br., Ex. 35: Letter from Larry D. Rogers, Director Corporate Income & Franchise Tax Division, and W.H. Baker, Jr., Supervisor Audit Section, to [redacted] (Jan. 22, 1987).) However, from 2000 to May 2010, the Department required combination in approximately 100 cases (Sadoff Dep. at 205:17–206:7), and the number of audits requiring combinations between 2000 and

2004 was up significantly when compared to the previous five years. (*See* Second Aff. of Donna Powell (“Second Powell Aff.”) (May 14, 2010), Ex. 32.) The increase in the number of consolidations resulted from a combination of forces: (1) the efforts of accounting firms like Coopers selling strategies for tax reduction by shifting assets and income among affiliated corporate entities; (2) the budget shortfall that developed in early 2001; and (3) as discussed below, the efforts initiated by then Secretary E. Norris Tolson and his deputies to increase revenue generation at the Department of Revenue.

{47} In 2001, E. Norris Tolson became the Secretary of Revenue for the State of North Carolina. (*See* Pl.’s Summ. J. Br., Ex. 73: E. Norris Tolson, Presentation to Council on State Taxation (Feb. 15, 2006) (“Tolson Presentation”) at 2.) Secretary Tolson became concerned that the Department was not collecting the amount of revenue it was owed. (Tolson Presentation at 2.) He thought that the Department should act more like a business and less like a government agency with regard to accounts receivable. (Tolson Presentation at 2.)

{48} He instituted a number of initiatives to collect more revenue for the state. In 2001 the Department initiated “Project Collect Tax” to collect delinquent taxes, and it built a Taxpayer Assistance and Collection Center to move collection efforts “in-house.” (Tolson Presentation at 3.) In 2003 the Department initiated “Project Compliance,” which focused on problems such as: non-filers, fraudulent return preparers, guest workers, and corporate tax issues like “income shifting.” (Tolson Presentation at 4–6.) In a February 15, 2006 speech to the Council on State Taxation, Secretary Tolson, stated:

Field auditors in the Examination Division discovered a number of tax avoidance techniques utilized by corporations to shift net income and avoid taxation by this state. These strategies generally involved wholly owned subsidiaries created to own trademarks or patents for which North Carolina operating companies “pay” royalties Tax avoidance techniques also involved the “moving” of income-producing intangible assets outside North Carolina into companies organized as LLCs or real estate investment trusts. These actions resulted in the significant loss of tax revenues by North Carolina. We have and will continue to pay a lot of attention to these activities.

(Tolson Presentation at 6.)

{49} In July 2001 Greg Radford was appointed the Director of the Corporate Excise and Insurance Tax Division. (Radford Dep. at 41:9–12.) As director, Mr. Radford’s primary responsibility was to supervise the employees of the division and to oversee the division’s responsibilities. (Radford Dep. at 30:24–31:1.) The division is responsible for interpreting and administering state tax laws and providing guidance to departmental employees, taxpayers, and professionals (lawyers and CPAs). (Radford Dep. at 31:1–16.) It publishes Technical Bulletins, provides private letter rulings to taxpayers, works on appeals, reviews tax bills under consideration by the Legislature, and recommends changes to the Legislature on tax compliance issues. (Radford Dep. at 31:1–16.) Part of the division’s responsibility is to establish policy concerning forced combinations. (Radford Dep. at 40:11–41:8.) The Department’s audit division then applies the Corporate Excise and Insurance Tax Division’s interpretations and/or policies to particular cases. (Radford Dep. at 40:14–23.)

{50} At the time of Delhaize’s audit, when corporate combinations were steadily increasing, the Department never issued any information in response to taxpayers’, lawyers’, or accountants’ requests for guidance on when the Department would require a combined return. (Radford Dep. at 370:1–22.) In fact, the Department could not issue any guidance to taxpayers on this issue because, as Mr. Radford stated, “there [are] no rules or criteria that we’ve established either to our auditors or to the public” that would apply to all taxpayers. (Radford Dep. at 163:9–11.) Mr. Radford stated that the Department chose not to publish guidelines because no two cases are exactly alike and because taxpayers would make decisions to reduce their tax obligations based on the new criteria. (Radford Dep. at 163:7–14, 370:1–22.) Additionally, they might challenge the Department through litigation. (Radford Dep. at 370:17–22.) He stated that “you have to have enough flexibility to examine all the facts in the case and make a good determination.” (Radford Dep. at 163:20–22.)

{51} In December 2000 John Sadoff was promoted to Director of the Department of Revenue's Examination Division, which conducts corporate audits. (*See* Sadoff Dep. at 11:2–24; 246:20–251:18). Before and during the Delhaize audit, the Department conducted no training for the auditors on when to require consolidation. Mr. Radford and his deputies never provided the auditors with any guidelines, any bright line tests, or any key facts to evaluate a case. (Sanderson Dep. at 27:12–28:2.) Nor did they provide any guidance to the auditors to determine what the term “true earnings” means. Mr. Sadoff held conferences with individual auditors assigned to particular cases to discuss the facts of each matter. (Dep. of Constance Michael Sanderson, Department Auditor (“Sanderson Dep.”) at 26:12–16.) Many times those conferences were one-on-one. (Sanderson Dep. at 26:23–25.) Mr. Sadoff had the authority to make the final determination on whether a consolidation would be ordered. (Sanderson Dep. at 31:1–10, 32:13–15.) “True earnings” would be determined on a case-by-case basis. (Sanderson Dep. at 26:3–4; 134:6–19; *See* Radford Dep. at 163:12–14.) Ultimately, Mr. Sadoff made a subjective judgment call.

{52} The Department's lack of guidance made even its own auditors confused. They repeatedly requested guidelines. David Simmons, leader of the Interstate Group, sent an email to his managers stating that “the overwhelming response” from staff members regarding issues they would like to be addressed is “‘Combinations’, but we knew that.” (Pl.'s Summ. J. Br., Ex. 68: Email from David Simmons to Interstate Managers (Mar. 15, 2006, 11:19 EST).) In another email, he stated that employees “desperately need[ed] guidelines” on combinations. Regardless, we are not going to get them.” (Pl.'s Summ. J. Br., Ex. 69: Email from David Simmons to Eric Wayne (Feb. 27, 2006, 15:53 EST).) Mr. Simmons asked Mr. Sadoff to help him develop “significant training” for the auditors on the issue of combinations. (Pl.'s Summ. J. Br., Ex. 70: Email from David Simmons to John Sadoff (Mar. 16, 2006, 08:58 EST).) He wrote: “There is a general consensus [from the audit staff] that most every corp[orate] audit they do, (there are currently something like 900 corp[orate] audit cases open) have [sic] the potential to be a

combination—and [the auditors] do not feel they know how, why, or when in many of these cases.” (Pl.’s Summ. J. Br., Ex. 70: Email from David Simmons to John Sadoff (Mar. 16, 2006, 08:58 EST).) Responding to Mr. Simmons, Mr. Sadoff reinforced the mantra that each case stands on its own. (Pl.’s Summ. J. Br., Ex. 70: Email from John Sadoff to David Simmons (Mar. 16, 2006, 09:06:23 EST).)

{53} In a March 21, 2006 email to four employees, Mr. Simmons stated that the Department would not give its own auditors guidelines for determining whether the income of affiliated corporations should be combined for tax purposes, in part because

the folks in Tax Admin don’t necessarily agree, Exams may or may not agree with T.A., the A.Gs office may or may not agree with either, yada, yada, yada. But part of it is also because of a legit fear that if we communicate “guidelines” to our audit staff, these will eventually fall into the hands of the dreaded Jung [sic] Hoard [sic] (also know [sic] as [taxpayers] and their representatives) and will be used against us.⁴

(Pl.’s Summ. J. Br., Ex. 72: Email from David Simmons to Gene Chavis, et al. (Mar. 21, 2006, 17:57 EST).) Mr. Simmons believed that the Department refused to provide guidelines to the public because taxpayers would restructure their transactions to fall outside the guidelines. If the Department published guidelines to taxpayers, it “would be like handing a gun to the guy that is about to rob us.” (Pl.’s Summ. J. Br., Ex. 71: Email from David Simmons to Interstate Managers (Mar. 22, 2006, 13:05 EST).)

{54} Secretary Tolson defended the Department’s position not to issue guidelines to taxpayers on combinations. He stated:

It has been suggested that the Department should issue some kind of guidelines as to when we will look to combine. Wouldn’t it be great if we could issue guidance that every taxpayer could rely upon and abide by. However, I think we are all smart enough to know that the result will be different. If we list criteria by which the Department will determine to combine, taxpayers might argue that their activities do

⁴ This term appears to be a reference to a 1982 fantasy/adventure film called “The Beastmaster.” In the film, the “Jun horde” is a race of beast-like warriors controlled by an evil sorcerer lustful for power. The marauding creatures pillage peaceful villages, murder innocents, and serve generally to antagonize the film’s rag-tag band of worthy and downtrodden heroes.

not meet those criteria and, therefore, combination is improper. If they were to meet the criteria but not like the result, they would just appeal the decision and argue that we have exceeded our authority or misinterpreted the law We will not issue such guidance!

(Tolson Presentation at 16–17.) The rationale for this policy was developed by Mr. Sadoff and Secretary Tolson in late 2005. (Sadoff Dep. at 372:14–373:14.) Neither Mr. Sadoff nor Secretary Tolson sought any legal advice or approval for this decision. (Sadoff Dep. at 373:15–19.)

{55} Yet, in 2006 Secretary Tolson stated that the “Department of Revenue’s mission is to administer the tax laws and collect the taxes due the State in an impartial, uniform, and efficient manner.” (Tolson Presentation at 1.) The Department’s goals are to “maximize tax compliance and State tax revenue, improve constituent services, and improve agency efficiency and effectiveness.” (Tolson Presentation at 1–2.)

{56} Secretary Tolson believed that companies could be protected from the requirement of combination and the assessment of additional tax and penalties in two ways. First, the taxpayer could file a request from the Department for a private ruling in advance. (Tolson Presentation at 17–18.) Second, after December 2004, corporations could avoid paying any tax penalties and the risk of prosecution associated with the “improper shifting” of income if the taxpayer agreed to pay all additional assessed tax obligations and interest when assessed. (Tolson Presentation at 18–19.) The Secretary stated that this Voluntary Compliance Program gives taxpayers “one more chance to come into compliance with the State’s Revenue Laws, have a clean slate and put bad business decisions . . . behind them.” (Tolson Presentation at 20.)

{57} The true earnings/fair compensation standard was not honored consistently before 2000, and it has since been abandoned by the Department, despite the fact that Technical Bulletins stated as late as 2008 that deductions between affiliates should be limited to amounts which are reasonable in relation to the goods or services received therefor. The Department no longer eliminates

payments in excess of fair compensation, and it no longer determines whether affiliated companies' charges to each other satisfy the arm's length standard of Section 482.

{58} Not only did the Department not give taxpayers notice of these policy changes; it also worked actively to conceal the standards its decision makers were using when exercising their authority to combine returns. The Department forced taxpayers to guess whether they would be subjected to compelled combination and resulting penalties.

{59} In this case, Ms. Sanderson, Delhaize's auditor, did not make specific determinations about the transactions between the affiliated companies. She did not attempt to determine the amount of fair profit that normally would arise from providing private label services or intellectual property rights to a company. (Sanderson Dep. at 127:3–6.) She did not determine whether FLFL's payments to Delhaize for its procurement services or private label development were in excess of fair compensation. (Sanderson Dep. at 127:3–128:13.) The facts she did consider when recommending a consolidation were as follows: that Food Lion transferred its employees to an affiliate but did not move the employees' offices, the assets that were moved, the way the new structure operated, the manner in which the income was shifted and deductions made, and both the federal and state tax consequences of the plan. (Sanderson Dep. at 119:17–23.)

III.

LEGAL STANDARD

{60} A trial court must grant summary judgment “when there is no genuine issue as to any material fact and any party is entitled to a judgment as a matter of law. Summary judgment is appropriate if: . . . the facts are not disputed and only a question of law remains . . .” *Wal-Mart*, 197 N.C. App. 30, 37, 676 S.E.2d 634, 641. Both parties in this case have filed Motions for Summary Judgment. As the parties agree on the material facts of this dispute, a summary disposition of the claims is proper and appropriate.

IV.
ANALYSIS

A.

CONSOLIDATION ORDER

{61} *Wal-Mart* held that the General Assembly granted the Secretary “discretionary authority to force combination of entities on a finding that a report does not disclose true earnings in North Carolina.” *Id.* at 50, 676 S.E.2d at 649. Discretionary decisions of administrative agencies will not be disturbed by the courts absent a clear manifest abuse of discretion. *Williams v. Burlington Indus.*, 318 N.C. 441, 446, 349 S.E.2d 842, 845 (1986).

The test for abuse of discretion is whether a decision is manifestly unsupported by reason or so arbitrary that it could not have been the result of a reasoned decision. The intended operation of the test may be seen in light of the purpose of the reviewing court. Because the reviewing court does not in the first instance make the judgment, the purpose of the reviewing court is not to substitute its judgment in place of the decision maker. Rather, the reviewing court sits only to insure that the decision could, in light of the factual context in which it is made, be the product of reason.

Little v. Penn Ventilator Co., 317 N.C. 206, 218, 345 S.E.2d 204, 212 (1986) (internal quotations and citations removed). The reviewing court may only decide

whether the action of the public official was contrary to law or so patently in bad faith as to evidence arbitrary abuse of his right of choice. If the officer acted within the law and in good faith in the exercise of his best judgment, the court must decline to interfere even though it is convinced the official chose the wrong course of action.

Burton v. Reidsville, 243 N.C. 405, 407–08, 90 S.E.2d 700, 702–03 (1956).

Additionally, the Court should presume the “good faith of tax assessors and the validity of their actions” *In re Appeal of AMP, Inc.*, 287 N.C. 547, 562, 215 S.E.2d 752, 762 (1975) (citing 72 Am. Jur. 2d State and Local Taxation § 713 (1974)).

{62} *Wal-Mart* effectively rejected each of Delhaize’s arguments with respect to combination. It foreclosed Delhaize’s constitutional arguments that the Secretary

violated the law by the arbitrary and capricious manner in which the Department forced a combination with FLFL; the Department's disparate treatment of similarly situated taxpayers when ordering the combination; and the violation of Federal Due Process rights with respect to the combination. Additionally, the Court found no evidence that would overcome the presumption of good faith afforded to tax collectors and their actions. It is clear that high ranking employees at the Department of Revenue were motivated to increase collections and that they implemented policies to achieve that result. When ordering Delhaize to combine its income with FLFL, officials at the Department were acting within their understanding of their authority.

{63} *Wal-Mart* also rejected Delhaize's assertion that the Secretary's administration of N.C. Gen. Stat. § 105-130.6 was unlawful. While implementing the Vision Project, Delhaize deliberately shifted its income to FLFL. This transfer resulted in a distortion of its income. The Secretary then determined through an audit that the true earnings of the company in North Carolina were not reflected in its 2000 tax return. Under the abuse of discretion standard reaffirmed in *Wal-Mart*, the Secretary's determination in this case was not clearly erroneous. Thus, based on these facts, Delhaize cannot establish that the Secretary's decision to combine its returns was arbitrary or unreasoned.

B.

PENALTY ASSESSED

{64} The Department abused its discretion when it ordered Delhaize to pay a twenty-five percent (25%) penalty upon ordering the consolidation because the order was contrary to established law.

{65} In *Wal-Mart*, the Court of Appeals upheld the Department's post-consolidation assessment of a penalty against Wal-Mart Stores East, Inc., the plaintiff appellant, totaling twenty-five percent (25%) of the tax assessed against it. *See* 197 N.C. App. at 58, 59, 676 S.E.2d at 653, 654. The Department assessed a twenty-five percent (25%) penalty because after the Secretary required the plaintiff

appellant to consolidate its return with its related subsidiaries, the company's original separate filing understated its new tax obligation by more than twenty-five percent (25%). *See id.* at 57, 58, 676 S.E.2d at 653. N.C. Gen. Stat. § 105-236(a)(5)(c) authorizes a twenty-five percent (25%) penalty for a "large tax deficiency" totaling twenty-five percent (25%) or more. N.C. Gen. Stat. § 105-236(a)(5)(c) (Lexis 2010).

{66} The plaintiff appellant argued that the assessment of a twenty-five percent (25%) penalty was improper because the Department's treatment of it was inconsistent with other corporate taxpayers and because the Department made no finding that it was negligent in failing to consolidate its tax returns. *See Wal-Mart*, 197 N.C. App. at 58, 676 S.E.2d at 653.

{67} Responding to Wal-Mart Stores East, Inc.'s argument that the assessment of the additional tax and the resulting penalties violated the tax uniformity requirement of Article V, Section 2(2) of the North Carolina Constitution and the Equal Protection Clause of the Fourteenth Amendment of the U.S. Constitution, the Court stated that a "taxpayer cannot establish its claim based solely on the treatment of other taxpayers." *Id.* at 51, 58, 676 S.E.2d at 649, 654 (referencing Part IV.C. of its opinion). Under the part of its opinion titled "Uniform Taxation," the Court stated: "[T]he rule of equality in taxation permits many practical inequalities. And necessarily so. What satisfies this equality has not been, and probably never can be, precisely defined." *Id.* at 52, 676 S.E.2d at 650 (quoting *Leonard v. Maxwell*, 216 N.C. 89, 94, 3 S.E.2d 316, 321 (1939)) (internal brackets omitted). "The mere fact that another taxpayer has been treated differently from the plaintiff does not establish the plaintiff's entitlement A taxpayer cannot premise its right to an exemption by showing that others have been treated more generously, leniently, or even erroneously by the IRS." *Id.* at 53, 676 S.E.2d at 650 (citing *Galveston by Galveston Wharves v. United States*, 33 Fed. Cl. 685, 707-08 (1995), *aff'd*, 82 F.3d 433 (Fed. Cir. 1996)). The Court held that Wal-Mart Stores East, Inc.'s inequality argument was without merit. *Id.* at 53, 676 S.E.2d at 650.

{68} The Court of Appeals also rejected plaintiff appellant’s contention that the Department was required to make a finding of negligence before assessing a penalty. It held that though the title of subdivision (5) of N.C. Gen. Stat. § 105-236(a) is titled “Negligence,” and though a finding of negligence is required to assess a ten percent (10%) penalty under N.C. Gen. Stat. § 105-236(a)(5)(a), no such finding is required to assess a twenty-five percent (25%) penalty for a large tax deficiency under N.C. Gen. Stat. § 105-236(a)(5)(c). *See id.* at 58, 676 S.E.2d at 653. Crucially, the Court noted that the plaintiff appellant did not “appear to dispute that if the Secretary’s assessment based on the combined return is lawful, then plaintiff’s income was understated by more than 25%, which operates to invoke the provision of N.C. Gen. Stat. § 105-236(a)(5)(a) without a finding of negligence.”⁵ *Id.*

{69} If the plaintiff appellant in *Wal-Mart* conceded that a lawful consolidation resulting in a deficiency of twenty-five percent (25%) or more automatically invokes the large penalty provision of N.C. Gen. Stat. § 105-236(a)(5)(c), then the question of whether that action is proper under the Due Process Clause of the United States Constitution or Article V, Section 2(1) of the North Carolina Constitution, or whether it is precluded by the plain reading of N.C. Gen. Stat. § 105-130.6 and § 105-236(a)(5), as they existed between 2000 and 2004, was not before the Court of Appeals. As Delhaize has not abandoned this ground, this Court may consider these issues.

{70} Future problems similar to those raised by the claims in this case have been generally addressed and eliminated by the July 2010 amendments to N.C. Gen. Stat. § 105-236. By those amendments, the General Assembly prohibited the Secretary from assessing a twenty-five percent (25%) automatic penalty upon ordering a combined return unless one of three conditions is met. N.C. Gen. Stat. § 105-236(a)(5)(f) (Lexis 2010). The condition relevant to this matter is that the Secretary must adopt permanent rules that describe the facts and circumstances

⁵ Based on the context of the paragraph that contains this quoted sentence, it appears to this Court that the Court of Appeals meant to reference paragraph (c) of subdivision (5) here, rather than paragraph (a).

under which the Secretary will require a combined return, and the taxpayer's facts and circumstances must meet those described in the rules. N.C. Gen. Stat. § 105-236(a)(5)(f)(2) (Lexis 2010). As of July 1, 2010, the Secretary may not order a combined return that generates a twenty-five percent (25%) penalty unless he or she has issued guidelines detailing when he or she will order consolidation, and the taxpayer's transactions fall within those guidelines. *See id.* If the corporate taxpayer ignores the guidelines, it does so at its own peril. If the Secretary refuses to provide guidelines, he or she may still order a combined return, but he or she does not have the ability to assess an automatic twenty-five percent (25%) penalty if the deficiency in the combined return exceeds twenty-five percent (25%) of the original tax. *See* N.C. Gen. Stat. §§ 105-130.6, 105-236(a)(5)(f) (Lexis 2010); 2010 N.C. Sess. Laws 31.10(b),(d). The Amendments were prospective, leaving this Court to determine whether Delhaize's constitutional rights at the time of the original penalty assessment were equivalent to those now contained in the statute. This Court believes they were and that the amendments recognized the inherent inequality in the use of the automatic twenty-five percent (25%) penalty by the Department.

1.

Due Process Clause of the Fourteenth Amendment

{71} It is true that in *Wal-Mart* the Court of Appeals determined that the Department's assertion of authority under N.C. Gen. Stat. § 105-130.6 to combine related entities' taxable income did not run afoul of the Due Process Clause of the United States Constitution. 197 N.C. App. at 37, 47, 49-51, 676 S.E.2d at 641, 647, 648-49. It held that the concept of "true earnings is a sufficiently definite standard" to allow the Secretary to order a combination and that the Secretary has "discretionary authority to force combination of entities" when it finds that a return does not disclose "true earnings in North Carolina." *Id.* at 50-1, 676 S.E.2d at 649. The Court made no mention, however, of whether the twenty-five percent (25%) penalty assessed in that case also could withstand constitutional scrutiny.

{72} The Fourteenth Amendment to the United States Constitution prohibits states from depriving “any person of life, liberty, or property, without due process of law” U.S. Const., Amdt. 14 § 1. The concept of due process is necessary to protect private parties from the abuses that flow from the expansive powers of centralized government. *See Holmes v. New York City Housing Auth.*, 398 F.2d 262, 265 (2d Cir. 1968) (“due process requires that [agency decisions] be made in accordance with ‘ascertainable standards’”). It is intended to protect individuals and corporations against the “arbitrary exercise of the powers of government unrestrained by the established principles of private right and distributive justice.” *County of Sacramento v. Lewis*, 523 U.S. 833, 845–846, 118 S. Ct. 1708, 1716 (1998). The Supreme Court has emphasized that

the touchstone of due process is protection of the individual against arbitrary action of government, . . . whether the fault lies in a denial of fundamental procedural fairness, *see, e.g., Fuentes v. Shevin*, 407 U.S. 67, 82, 32 L. Ed. 2d 556, 92 S. Ct. 1983 (1972) (the procedural due process guarantee protects against “arbitrary takings”), or in the exercise of power without any reasonable justification in the service of a legitimate governmental objective, *see, e.g., Daniels v. Williams*, 474 U.S. [327, 331, 88 L. Ed. 2d 662, S. Ct. 662 (1986)] (the substantive due process guarantee protects against government power arbitrarily and oppressively exercised).

Id. (internal quotations removed). While the Department’s assessment of an automatic penalty here does not rise to a level of oppression that would “shock the conscience,” and thereby violate substantive due process, *Id.* at 848, 118 S. Ct. at 1717; *see also Eichenlaub v. Twp. of Ind.*, 385 F.3d 274, 285–86 (3rd Cir. 2004) (tax assessment), the assessment does raise serious questions concerning its comportment with procedural due process.

{73} “Procedural due process imposes constraints on government decisions which deprive individuals of ‘liberty’ or ‘property’ interests within the meaning of the Due Process Clause of the Fifth or Fourteenth Amendment.” *Matthews v. Eldridge*, 424 U.S. 319, 333, 96 S. Ct. 893, 902 (1976). As a threshold matter, penalties paid by taxpayers to the government are property interests protected by

procedural due process. *See e.g. Kahn v. United States*, 753 F.2d 1208, 1217–22 (3rd Cir. 1985) (Fifth Amendment); *Scull v. United States*, 585 F. Supp. 956, 958, 960 (E.D. Va. 1984) (Fifth and Fourteenth Amendments); *Drefchinski v. Regan*, 589 F. Supp. 1516, 1523–524 (W.D. La. 1984) (Fifth Amendment). Thus, this Court can consider whether the automatic twenty-five percent (25%) penalty assessed after the Department ordered a consolidation without any guidelines to its own auditors or to taxpayers qualifies as sufficient notice required by the Due Process Clause of the Fourteenth Amendment. Generally, individuals with a property interest protected under the clause must receive notice and an opportunity to be heard before the government may deprive them of their property. *United States v. James Daniel Good Real Property*, 510 U.S. 43, 48, 114 S. Ct. 492, 498 (1993). This requirement minimizes the risk of substantively unfair or mistaken property deprivations at the hands of government. *See id.* at 53, 114 S. Ct. at 501. When conduct is prohibited, procedural due process requires that the “conduct be described so that ‘the ordinary person exercising ordinary common sense can sufficiently understand and comply’” *Scull*, 585 F. Supp. at 961 (quoting *Civil Serv. Comm’n v. Nat’l Assoc. of Letter Carriers*, 413 U.S. 548, 579, 93 S. Ct. 2880 (1973)) (IRS tax penalty assessment).

{74} In *Wal-Mart*, The Court of Appeals indicated that Wal-Mart Stores East, Inc. conceded the following point: when the Secretary lawfully orders a combined return that results in understatement of tax obligation by at least twenty-five percent (25%) upon the original single entity tax return, the penalty invoked is automatic. It is probable, if not axiomatic, that anytime the Department orders a combined return, the result would be an automatic twenty-five percent (25%) penalty, regardless of negligence. Thus, taxpayers, including this taxpayer, were faced with a tax structure intentionally designed by the Department under which they: (1) would be permitted to file only a single entry return, (2) had no guidelines for when the Department would require them to file a combined return, and (3) face a virtually automatic twenty-five percent (25%) penalty if they were forced to file a combined return, even though they paid the tax required by the Department under

the combined return when due. Thus, after an audit, the taxpayer receives a substantial penalty for following the law.

{75} 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, then ordinary taxpayers "exercising ordinary common sense" cannot sufficiently understand or predict when a penalty will be assessed. *Scull*, 585 F. Supp. at 961. Additionally, taxpayers cannot arrange their affairs to avoid punishment because no published criteria exists with which they can comply.

{76} Tax penalties in North Carolina are punitive in nature rather than remedial. *See N.C. Sch. Bds. Ass'n v. Moore*, 359 N.C. 474, 491, 614 S.E.2d 504, 514–15 (2005). Sanctions that are remedial impose "additions" to tax owed and "are provided primarily as a safeguard for the protection of the revenue and to reimburse the Government for the heavy expense of investigation . . ." *N.C. Sch. Bds. Ass'n v. Moore*, 160 N.C. App. 253, 271, 585 S.E.2d 418, 430 (2003) (quoting *Helvering v. Mountain Producers Corp.*, 303 U.S. 391, 401, 58 S. Ct. 630 (1938)) (italics removed), *rev'd on other grounds, Moore*, 359 N.C. 474, 614 S.E.2d 504 (2005). Sanctions that are punitive, on the other hand, are intended to punish taxpayers who do not comply with the tax code and to deter that non-compliance. Here, the Department punished Delhaize for properly filing separate returns according to the only method permitted under North Carolina law. It assessed a substantial penalty for understating a tax obligation that Delhaize had no duty to pay when it filed its original return and could not have known it would be required to pay later. The tax structure resulting in this penalty assessment was fundamentally unfair and has been corrected by the Legislature.

{77} Moreover, the Department's assessment of a large penalty against Delhaize is an arbitrary and abusive exercise of power that serves mainly to coerce taxpayers into submitting to its will. The club of the twenty-five percent (25%) penalty was deftly employed by the Department when it created an 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.

Taxpayers could thereby avoid a protracted legal battle. The Department was thus able to deny taxpayers (i.e., the dreaded “Jun horde”) any means of contesting the Department’s position without subjecting themselves to the automatic punitive penalty and subsequent litigation.

{78} In describing a previous tax case at a symposium, under a section titled “So you want to go to Court?” the Department’s counsel cautioned corporations that “litigation takes deep pockets and long-term commitment.” (39th Annual Legal Symposium State Taxation of Franchise Royalties, Recent Litigation—The Inside Story, by Kay Miller Hobart.) She asked, “Is it worth it to your company?” *Id.* The twenty-five percent (25%) penalty, coupled with the Voluntary Compliance Program existing at the time of the Delhaize audit, presented audited companies with the same question: Is going to court worth the risk? Most corporations in Delhaize’s position paid the additional tax, avoided the penalty by agreeing to comply with the Department’s assessment, and avoided the ensuing court battle. The Department’s automatic, punitive twenty-five percent (25%) penalty has significant coercive power which, when wielded in these circumstances, violated due process.

{79} *Wal-Mart* blessed the Department’s authority to order consolidations without publishing guidelines about when those combinations will be required. It did not bless, however, the automatic assessment of a twenty-five percent (25%) penalty any time a consolidation results in a deficiency of twenty-five percent (25%) or more when taxpayers and Department auditors are given no guidelines. In *Wal-Mart*, The Court of Appeals did not have before it the full facts developed on the record in this case. The lack of any guidelines from the Department and the summary fashion in which a few select Department employees assess punitive substantial penalties result in taxpayers having insufficient notice that they will be assessed a penalty as punishment for a tax deficiency resulting from combination. Additionally, the Department’s intentional use of the club of the twenty-five percent

(25%) automatic penalty to coerce taxpayers into paying the new assessment is an arbitrary abuse of power.

{80} The Secretary may not change the policy (which had been previously announced) while failing to issue guidelines on the new policy, and then assess a penalty on a return the taxpayer could not originally have filed and on a basis for which the Secretary refused to provide guidelines not only to taxpayers, but also to its own staff. That course of action is arbitrary and capricious. The Department's assessment of the penalty against Delhaize is unfair and is a violation of the Fourteenth Amendment's procedural due process protections.

{81} Because the Court determines that the Department's insufficient notice and coercive practices are themselves violative of due process, it does not consider whether taxpayers have a sufficient opportunity to be heard before the penalty is assessed.

2.

The Power of Taxation Clause of the North Carolina Constitution

{82} There is another relevant constitutional issue applicable to the case before this Court that did not form a basis for the Court of Appeals' decision in *Wal-Mart*. That issue is not whether the twenty-five percent (25%) penalty assessed against Delhaize violated the uniformity requirement of Article V, Section 2(2) of the North Carolina Constitution, but whether the penalty assessed violated a more basic principle, the requirement that the power of taxation be exercised in a just and equitable manner, pursuant to Article V, Section 2(1) of the North Carolina Constitution. Article V, Section 2(1), titled "Power of taxation," states: "The power of taxation shall be exercised in a just and equitable manner, for public purposes only, and shall never be surrendered, suspended, or contracted away." N.C. Const. This section "is a limitation upon the legislative power, separate and apart from the limitation contained in the Law of the Land Clause in Article I, § 19, of the Constitution of North Carolina, and the Due Process Clause of the Fourteenth

Amendment to the Constitution of the United States.” *Foster v. N.C. Med. Care Comm’n*, 283 N.C. 110, 126, 195 S.E.2d 517, 528 (1973).

{83} The Department’s penalty assessment violates the Power of Taxation Clause for three reasons. First, it creates a disparity in the treatment of taxpayers without a rational reason. In his deposition, Gregory Radford, the Director of the Corporate, Excise and Insurance Tax Division between 2001 and 2009, acknowledged that he was aware of no instance in which an audit resulted in a forced combination that decreased the taxpayer’s tax liability or left the taxpayer’s tax liability unchanged. (Radford Dep. at 274.) Indeed, the impetus for instituting Project Compliance in 2003 was to increase the Department’s collections. (Tolson Presentation at 4–6.) Mr. Radford stated at the September 5, 2006 meeting of the North Carolina General Assembly’s Revenue Laws Study Committee that “the Department of Revenue cannot audit all inter-company transactions between related companies, one or more of which is doing business in North Carolina.” *Wal-Mart*, 197 N.C. App. at 51, 676 S.E.2d at 650. If the Department cannot audit all cases that have a potential for consolidation, it is likely to focus its limited resources on what it perceives to be the most egregious offenders (i.e., those that will generate the most income for the state).

{84} In those instances where the variance between separate and combined filings is *less* than twenty-five percent (25%), under N.C. Gen. Stat. § 105-236(a)(5)(a), the Department would be required to find that an audited corporation was negligent in failing to file a consolidated return before it could enforce a ten percent (10%) penalty. Of course, this finding is impossible, because under N.C. Gen. Stat. § 105-130.14, corporations can only be *required* to file consolidated returns; they cannot elect to do so voluntarily. A corporation cannot be negligent for obeying the law. When the Department audited Delhaize, if the variance in tax obligations between the original separate return and the consolidated return had been less than twenty-five percent (25%), the Department would have been precluded from assessing any penalty.

{85} But, because the variance was greater than twenty-five percent (25%), under *Wal-Mart*, no finding of negligence is required to assess a large penalty under N.C. Gen Stat. § 105-236(a)(5)(c). That structure gives the Department the incentive to focus its efforts on cases like this one, where the variance between reported income under a separate corporate filing and the reported income after consolidation will be twenty-five percent (25%) or greater and where the penalty assessment is automatic.

{86} If the Department may assess a twenty-five percent (25%) penalty under these circumstances, then a corporation whose restated tax obligation after consolidation is less than twenty-five percent (25%) of its original tax obligation cannot be assessed a penalty, but a corporation whose new obligation, like Delhaize, is twenty-five percent (25%) or more faces an automatic penalty. Under the law as it existed until July 2010, a twenty-five percent (25%) penalty was certain to be assessed when the variance between filings is twenty-five percent (25%) or greater because, under *Wal-Mart*, the Department is not required to make a negligence finding. *See* 197 N.C. App. at 58, 676 S.E.2d at 653–54. In essence, N.C. Gen. Stat. § 105-236(a)(5)(c) (as it existed between 2000 and 2004) creates a strict liability punishment for corporations that fall into this category. *See Moore*, 359 N.C. 474 at 491, 614 S.E.2d at 514–15 (2005) (describing tax penalties as punitive rather than remedial). Even though the rule of equality in taxation permits many “practical inequalities,” *Wal-Mart*, 197 N.C. App. at 52, 676 S.E.2d at 650, this particular disparity in taxpayer treatment is without a rational basis. *See Farmers’ and Merchs.’ Bank v. United States*, 476 F.2d 406, 409 (4th Cir. 1973) (“The Commissioner cannot tax one and not tax another without some rational basis for the difference.”) The disparity is unnecessary and unjust. It is a violation of Article V, Section 2(1) of the North Carolina Constitution.

{87} Secondly, assessing a punitive penalty when Delhaize followed the law is itself unjust and inequitable. As noted above, North Carolina is a separate filing state. North Carolina General Statutes prohibit corporate taxpayers from filing consolidated returns. Before January 1, 2008, affiliated taxpayers could not even

obtain permission to file a consolidated return. (*See* Sadoff Dep. at 199.) Yet, under N.C. Gen. Stat. § 105-130.6, the Department of Revenue may force the combination of affiliated companies' returns if it believes that the true earnings of audited corporations are not reflected in their separate returns. Under *Wal-Mart*, it may do so though it provides no guidance to its own auditors or taxpayers on the circumstances that will result in combinations. If it may also assess a substantial penalty for a company's failure to file a consolidated return that it could not have legally filed at the outset, then the taxpayer receives a substantial penalty for following the law. Under North Carolina law, Delhaize was required to file a separate return in 2000. If it had filed a consolidated return, it would have violated statutory requirements. Yet, it faces a twenty-five percent (25%) penalty totaling \$1,188,008 because it did not file a combined return. The Department assessed this penalty even though it published no guidance on when combined returns would be required.

{88} When a corporation is charged a significant penalty for complying with the law, the result of which is an automatic, non-negligence, punitive penalty assessed by the Department of Revenue, the state's power of taxation is being exercised in a manner that is unjust and inequitable. For this reason also, the twenty-five percent (25%) penalty assessed by the Department is a violation of Article V, Section 2(1) of the North Carolina Constitution.

{89} Third, it would be unjust to allow the Department to assess Delhaize with a substantial penalty in this case when the General Assembly recognized the legal problems with this tax structure and in 2010 amended the tax penalty statute to require that the Secretary adopt "permanent rules . . . that describe the facts and circumstances under which Secretary will require a consolidated or combined return" before the Department may assess a twenty-five percent (25%) penalty. N.C. Gen. Stat. § 105-236(a)(5)(f)(2) (Lexis 2010). Taxpayers should now have the benefit of published guidelines to anticipate the imposition of a substantial penalty. Requiring Delhaize to pay this punitive penalty assessed in 2004 without published guidelines when other corporations, now with the benefit of recent legislation, may

arrange their affairs to comply with the Department standards would be inequitable and a violation of the power of taxation under Article V, Section 2(1) of the North Carolina Constitution.

3.

Statutory Authority

{90} Because the plaintiff appellant in *Wal-Mart* apparently did not dispute the automatic invocation of the twenty-five percent (25%) penalty provision whenever the Secretary lawfully requires a combination that results in an understated tax obligation of twenty-five percent (25%) or more, the question of whether N.C. Gen Stat. § 105-130.6 on its face allows this penalty under these circumstances was not before the Court of Appeals. Delhaize has not conceded this point.

{91} In *Wal-Mart*, the plaintiff appellant argued that the Department could not require a consolidation without a finding that inter-company payments were in excess of fair value. *See* 197 N.C. App. at 38, 676 S.E.2d at 642. Under this construction, the Department could determine that a corporation did not disclose its “true earnings,” as required under the statute, only if payments to or charges by related entities were in excess of those it could expect from an unrelated party in an arm’s length transaction, and the Department could order a consolidation only upon such a finding. *See id.* The Court concluded that the statute on its face does not so limit the Secretary’s authority. *See id.* at 39, 676 S.E.2d at 642. The “language of the statute is broad, allowing the Secretary to require combined reporting if he finds as a fact that a report by a corporation does not disclose the true earnings of the corporation on its business carried on in this State.” *Id.* This authority is not limited by a “particular type of transaction or dealing.” *Id.*

{92} Courts should interpret statutes as “not [to] render any provision meaningless.” *In re K.W.*, 191 N.C. App. 812, 815, 664 S.E.2d 66, 68 (2008). *Wal-Mart’s* interpretation of N.C. Gen. Stat. § 105-130.6 to allow the Department to order a consolidation without a determination of fair compensation does not render the first sentence of the statute a nullity. Rather, it effectively leaves the

Department with a choice. After an audit, the Department can determine that a company's reported net income is improperly stated because payments to or charges by affiliated companies are in excess of fair value. Or, it can make a finding that the return filed by the corporation does not disclose the true income of the company on its business carried on in this State. If it chooses the former, and if it can demonstrate that intercompany payments were in excess of fair value, then it would have the authority to assess a twenty-five percent (25%) penalty consistent with and pursuant to N.C. Gen. Stat. § 105-236(5)(c). The Department also is authorized to assess a penalty pursuant to the general penalty provision in N.C. Gen. Stat. § 105-130.6, which allows it to assess penalties as provided in N.C. Gen. Stat. §§ 105-230 and 105-236 when a "parent, subsidiary, or affiliated corporation" does not incorporate in its return information the Secretary needs to determine net income, or if the corporation does not provide any additional information the Secretary requires within thirty (30) days after it is demanded. N.C. Gen. Stat. § 105-130.6 (Lexis 2010).

{93} If the Department chooses the latter, however, the consolidation itself is its remedy. If the Department wishes to assess a penalty in addition to the consolidation, it must abide by the language of N.C. Gen. Stat. § 105-130.6 and N.C. Gen. Stat. § 105-236(5) concerning penalties and consolidated returns. Section 105-130.6 states: "[i]f a consolidated return required by this section is not filed within 60 days after it is demanded, then the corporation is subject to the penalties provided in G.S. 105-230 and G.S. 105-136." *Id.* Effective July 1, 2010, Section 105-236(5)(f) provided the Secretary *additional* authority to assess a penalty on a consolidated return, but only when: (1) the return is an amended consolidated return for the same entities as the initial consolidated return and is filed at the Secretary's request; (2) the Secretary publishes guidelines it will use to determine that consolidation is required, and the taxpayer's facts meet those described in the guidelines; or (3) at the written request of the taxpayer, the Secretary provides written advice that a consolidation is required. N.C. Gen. Stat. § 105-236(5)(f) (Lexis 2010).

{94} The provision granting the additional authority did not exist in 2004 when the Department assessed the penalty against Delhaize. At that time, Section 105-236(5) was silent on penalties assessed after consolidation. Therefore, the only authority in 2004 for assessing a penalty after a required consolidation was contained within N.C. Gen. Stat. § 105-130.6. That section allowed a penalty to be assessed only when a consolidated return was filed later than sixty (60) days after demanded, or if the general penalty provision noted above was applicable.

{95} Here, the Department could have made a determination that Delhaize's transactions with FLFL were in excess of fair compensation. It did not. It stated only that Delhaize's true earnings in North Carolina were not reflected in its tax return, and it ordered a consolidation. That choice was an option that *Wal-Mart* deems proper. Because the Department did not allege that Delhaize failed to file a consolidated return more than sixty (60) days after it was demanded and failed to allege a violation of the general penalty provision of N.C. Gen. Stat. § 105-130.6, however, the Department may not assess a twenty-five percent (25%) penalty against Delhaize.

{96} The Secretary abused his discretion in ordering the twenty-five percent penalty.

V.

CONCLUSION

{97} Based on the foregoing, it is hereby ORDERED, ADJUDGED, and DECREED that Defendant's Motion to Dismiss is DENIED. Defendant's Motion for Summary Judgment is GRANTED IN PART and DENIED IN PART. Plaintiff's Motion for Summary Judgment is GRANTED IN PART and DENIED IN PART. Plaintiff is entitled to a refund of the penalty assessed by the Defendant in the amount of \$1,188,008.00.

IT IS SO ORDERED, this 12th day of January, 2011.