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INTRODUCTION

Tax avoidance\(^1\) is as American as apple pie. Each year, individuals, families, and businesses alter their behavior in ways meant to decrease their federal, state, or local tax liabilities.\(^2\) Examples range from wealthy parents gifting stock to their children in order to decrease the applicable marginal tax rate upon its sale,\(^3\) to corporations identifying and navigating complex tax loopholes.\(^4\) As

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1. It is important to distinguish between tax avoidance and tax evasion. Tax avoidance refers to taxpayers structuring transactions to yield the lowest possible tax burden. Tax avoidance is not criminal although, as discussed in Part III, some tax benefits might be disallowed. In contrast, tax evasion refers to taxpayers illegally failing to pay taxes owed. See, e.g., Jean-Claude Goldsmith, Preface to INT'L BAR ASS'N, TAX AVOIDANCE, TAX EVASION, at vii, vii (1982) [hereinafter TAX AVOIDANCE, TAX EVASION] (discussing “the border line between the forbidden and allowed”); Michael Doran, Tax Penalties and Tax Compliance, 46 HARV. J. ON LEGIS. 111, 124 n.69 (2009) (referencing “the familiar but elusive distinction” between tax avoidance and tax evasion). Tax avoidance has been described as the “legal structuring of conduct to avoid incurring tax obligations,” whereas tax evasion has been described as “illegal non-reporting of income or non-payment of taxes.” Doran, supra, at 124 n.69 (citing Michael G. Allingham & Agnar Sandmo, Income Tax Evasion: A Theoretical Analysis, 1 J. PUB. ECON. 323, 323–24 (1972)).

2. According to the IRS, the annual U.S. federal tax gap (defined as “the difference between the amount of tax due from legal activities and the amount voluntarily paid by taxpayers in a timely manner”) is $300–$350 billion. George K. Yin, JCT Chief Discusses the Tax Gap, 107 TAX NOTES 1449, 1449 (2005). The majority of this figure results from “underreporting,” which includes certain tax avoidance strategies such as “complex tax shelter[s].” Id. This figure, however, only accounts for taxes that should have been paid according to government officials. See id. The real revenue loss from behavior alteration is therefore significantly higher.

3. See Mary Beth Franklin, Congress Closes Kiddie-Tax Loophole, KIPLINGER’S PERS. FIN., June 6, 2007, http://www.kiplinger.com/features/archives/2007/06/kidtax.html (explaining how tax loopholes allowed wealthy individuals to gift stocks and other financial assets to their children to decrease the family’s overall tax, that gifts are not taxed under the federal tax code, and that the capital gains rate varies depending on annual income).

4. See, e.g., Phil Mintz & Jane Sasseen, Changing Corporate Tax Rules: A Tough Road Ahead, BUS. WK., May 4, 2009, http://www.businessweek.com/bwdaily/dnflash/content/may2009/db2009054_337394.htm?chan=top+news_top+news+index+temp_top_story (explaining that the Obama administration hopes to raise $210 billion over ten years by closing corporate tax loopholes that largely allow international companies to “defer[] taxes on profits earned overseas indefinitely”).
the complexity of these tax loopholes increases, so does public skepticism regarding tax avoidance. The 2009 North Carolina Court of Appeals case *Wal-Mart Stores East, Inc. v. Hinton* involved one such example of complex corporate tax avoidance.

Wal-Mart had essentially developed a business structure that decreased its corporate tax liability in several states by having its store-owner subsidiary make rental payments to a recently established real estate trust; the trust then cycled these payments back to the original payor in the form of dividends. The store-owner subsidiary deducted the rental payments from its state corporate income taxes as a business expense, and under the state's tax code, it owed no tax on the dividend payments received. Simply put, Wal-Mart decreased its state tax liabilities by paying itself rent. In 2005, the North Carolina Secretary of Revenue, Reginald Hinton, responded to these actions by ordering Wal-Mart Stores East, Inc. (corporate owner of all Wal-Mart stores in North Carolina and twenty-nine other states) to pay roughly $20 million in back taxes plus nearly $6 million in interest and close to $5 million in late payment penalties. The Department of Revenue based these figures on the total tax owed when earnings of the various corporate entities involved in the real estate payment system were combined for tax purposes pursuant to state corporate income tax law. Wal-Mart Stores East made the approximately $30 million payment and then filed suit in state court, arguing that the Secretary of Revenue lacked the statutory authority to order a forced combination.

In May 2009, the North Carolina Court of Appeals unanimously upheld the Secretary's actions. The size of the tax bill and the

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5. __ N.C. App. __, 676 S.E.2d 634 (2009).
7. Id.
10. Id. at __, 676 S.E.2d at 640.
11. Id. at __, 676 S.E.2d at 641.
12. Id. at __, 676 S.E.2d at 654. The court of appeals also filed a simultaneous decision in an identical case involving Sam's East, Inc. (corporate owner of Sam's Club stores in North Carolina) based on its reasoning in *Wal-Mart Stores East*. See Sam's East, Inc. v. Hinton, __ N.C. App. __, 676 S.E.2d 654 (2009); see also *Wal-Mart Stores East*, __ N.C. App. at __, 676 S.E.2d at 641 (indicating that the court planned to submit an opinion regarding the Sam's East appeal simultaneously with its *Wal-Mart Stores East* opinion). The Secretary of Revenue had assessed Sam's East $3.5 million in back taxes and penalties resulting from the same tax avoidance strategy. Wal-Mart Stores East, Inc. v. Hinton, No.
closing of a popular tax loophole made Wal-Mart Stores East a noteworthy decision. The case received a fair amount of national media attention, largely because Wal-Mart and several other corporations utilized similar tax avoidance strategies in other states. In North Carolina, Wal-Mart Stores East also represents an important development for a state judiciary with a limited record of addressing incidents of corporate tax avoidance, and it shining new light on the state's difficulty in curbing instances of avoidance that border on the edge of evasion.

This Recent Development argues that although the North Carolina Court of Appeals reached the correct result from a public policy standpoint in Wal-Mart Stores East, it did so after conducting an incomplete statutory analysis. In conducting its statutory interpretation, the court of appeals failed to consider the individual provisions of title 105, section 130.6 of the General Statutes of North Carolina, and the court improperly distinguished the statute's legislative history and law from other jurisdictions. Underlying this incomplete analysis was the inability of the state's tax statutes to respond to new and evolving corporate tax avoidance strategies. In future cases, North Carolina courts should apply anti-tax avoidance judicial doctrines to egregious cases of tax avoidance in which state officials lack clear statutory authority to intervene. Anti-tax avoidance doctrines work more broadly than specific tax statutes by allowing state officials to disallow tax benefits that result from transactions structured solely to reduce tax liabilities and that lack an independent economic purpose.

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14. See Drucker, supra note 6 (describing Wal-Mart's use of the tax avoidance strategy and noting that other retailers and banks also utilize it).

15. See, e.g., Gulf Oil Corp. v. Clayton, 267 N.C. 15, 24, 147 S.E.2d 522, 529 (1966) (stating that "exploring ways [for the corporation] to minimize taxes is as much a part of its business as exploring for new sources of oil" and implicitly endorsing "[t]ax avoidance by any means which the law permits"). Additionally, as discussed in Part III.B, North Carolina courts have not applied the useful tool of anti-tax avoidance judicial doctrines.

16. N.C. GEN. STAT. § 105-130.6 (2009).

Applying these doctrines would help North Carolina achieve important policy benefits, including protecting state revenues, providing for simpler tax law, promoting fairness between individual and corporate taxpayers, and promoting economic efficiency. In addition, limiting application to only the most egregious cases of tax avoidance would minimize the negative consequences of applying these doctrines.  

Part I of this Recent Development discusses Wal-Mart Stores East’s relevant corporate structure and the North Carolina Court of Appeals’ decision. Part II examines the court’s statutory interpretation of section 105-130.6, arguing that the court misapplied established principles of statutory construction. Part III examines the relevant policy considerations and the use of anti-tax avoidance judicial doctrines in other jurisdictions. It concludes by recommending that North Carolina apply the doctrines in future cases to combat egregious acts of tax avoidance.

I. SUMMARY OF WAL-MART STORES EAST

A. Wal-Mart Stores East’s Relevant Corporate Structure

Wal-Mart is often viewed as one large retail business, but its corporate structure is significantly more complicated. For the purposes of Wal-Mart Stores East, the pertinent players were Wal-Mart Stores East, Inc., Wal-Mart Property Company, and Wal-Mart Real Estate Business Trust. The corporate structure that Wal-Mart established between these subsidiaries is what allowed it to avoid nearly $20 million in North Carolina corporate income taxes over the four-year period between 1998 and 2002.  

While the particular details of how these entities interacted have little bearing on this Recent Development’s overall analysis, it is important to note the complexity of Wal-Mart’s tax avoidance strategy. Wal-Mart Stores, Inc. (the primary Wal-Mart corporation) owns Wal-Mart Stores East, Inc. (“Wal-Mart Stores East”), which operates all the Wal-Mart stores in North Carolina and twenty-nine

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18. Under the egregious/non-egregious distinction, those taxpayers who structure transactions with zero economic purpose but to avoid taxes and who manage to keep significant funds from the treasury would face enforcement, but others would not. See infra notes 156–58 and accompanying text.

19. Drucker, supra note 6 (describing how Wal-Mart decreased its state tax liability by twenty percent over four years).
other states. In 1996, Wal-Mart Stores, Inc. reorganized its corporate structure in order to decrease state tax liabilities. As a result of the reorganization, Wal-Mart Stores East became the sole owner of WSE Investment, LLC. WSE Investment, LLC became the 99% owner of Wal-Mart Stores East, LP, and Wal-Mart Stores East, LP became the sole owner of Wal-Mart Property Company ("W-M PC"). Wal-Mart Stores East therefore had direct control over W-M PC even though they were distinct business entities separated by two degrees of corporate hierarchy. W-M PC owned all the voting shares of Wal-Mart Real Estate Business Trust ("W-M REBT"), a Delaware-based real estate investment trust ("REIT"). Wal-Mart Stores, Inc. transferred legal ownership of the land on which its retail stores were located to W-M REBT. Wal-Mart Stores East then entered into leases with W-M REBT for its individual retail stores, which included at least eighty-two stores in North Carolina. In sum, W-M REBT held all Wal-Mart Stores, Inc. real estate and was Wal-Mart Stores East's landlord even though Wal-Mart Stores East controlled W-M PC, which owned all the shares of W-M REBT.

This new "captive REIT" corporate structure allowed Wal-Mart Stores, Inc. to implement its tax avoidance strategy. Wal-Mart Stores East made rental payments to W-M REBT for the land on

21. Id.; see also Drucker, supra note 6. Wal-Mart Stores, Inc. purchased this financial plan from the accounting firm Ernst & Young. Drucker, supra note 6. It is fairly common for financial firms to sell business strategies to corporations that can save them money, such as by reducing state or federal tax liabilities. See id. Financial firms even go so far as to patent these plans. See Floyd Norris, Patent Law Is Getting Tax Crazy, INT'L HERALD TRIB., Oct. 20, 2006, at 12.
22. Wal-Mart Stores East, __ N.C. App. at __, 676 S.E.2d at 638. Wal-Mart Stores East also became the sole owner of WSE Management, LLC. Id.
23. Id.
24. Id. A real estate investment trust ("REIT") is simply "[a] company that invests in and manages a portfolio of real estate, with the majority of the trust's income distributed to its shareholders." BLACK'S LAW DICTIONARY 1378 (9th ed. 2009). "Congress created REITs in 1960 as a way to allow smaller investors to put money in a wide portfolio of commercial real estate, spreading their risk." Drucker, supra note 6. To incentivize the use of REITs, Congress also granted them favorable tax treatment: "REITs aren't subject to corporate income tax on the profits they pay to shareholders as long as they pay out at least 90% of the profits." Id.
25. Wal-Mart Stores East, __ N.C. App. at __, 676 S.E.2d at 639.
26. Id. This figure includes both lease and sublease arrangements. Id.
27. The term "captive REIT" is used to refer to corporate structures in which businesses benefit from REITs that remain essentially under their control. See Drucker, supra note 6.
which its individual retail stores were located. Wal-Mart Stores East then deducted the rental payments as a business expense on its North Carolina corporate income tax filings. Once W-M REBT received these rental payments, it paid them back to W-M PC (its one hundred percent shareholder) as dividends. W-M PC then transferred the majority of these funds back to Wal-Mart Stores East. Wal-Mart Stores East did not have to pay taxes on the dividend payments under North Carolina law. The end result was that Wal-Mart Stores East kept nearly the same amount of income it would have had under the pre-1996 corporate structure. However, it did not pay state taxes on the rent paid to W-M REBT even though almost all the money came back as dividend payments. This strategy decreased Wal-Mart Stores East’s North Carolina corporate income taxes by nearly $20 million over a four-year period.

28. Wal-Mart Stores East, __ N.C. App. at __, 676 S.E.2d at 639.
29. Id.
30. See id. at __, 676 S.E.2d at 640; Drucker, supra note 6.
32. See id; Drucker, supra note 6. Because dividends received by a parent corporation from a subsidiary normally are not taxed, Wal-Mart Stores East was able to deduct the dividend payments as nonbusiness income under title 105, section 130.4 of the General Statutes of North Carolina. Wal-Mart Stores East, __ N.C. App. at __ & n.3, 676 S.E.2d at 639-40 & n.3 (describing the application of N.C. GEN. STAT. § 105-130.4); see also Drucker, supra note 6 (explaining that laws “on the state level” allow “companies to receive dividends tax-free from their subsidiaries”). North Carolina also did not tax W-M REBT on the original dividend payment. See N.C. GEN. STAT. § 105-130.12 (2005) (amended 2007) (stating that a REIT “shall be taxed under this Part upon only that part of its net income which is not distributed or declared for distribution to shareholders”); see also Wal-Mart Stores East, __ N.C. App. at __, 676 S.E.2d at 639-40 (describing the method by which W-M REBT deducted as a dividend payment nearly all of its would-be taxable income). Furthermore, W-M PC did not owe any Delaware taxes on the dividend payments because of the Delaware tax code’s complete exemption for corporate dividend payments. See Drucker, supra note 6. In 2007, the North Carolina General Assembly amended section 105-130.12 to include dividend payments in the taxable income of a “captive REIT.” Act of July 31, 2007, ch. 323, § 31.18(c), 2007 N.C. Sess. Laws 616, 941-42 (codified at N.C. GEN. STAT. § 105-130.12 (2009)). The amendment was in response to the captive REIT tax avoidance structure utilized by Wal-Mart and other corporations. See infra notes 97-98 and accompanying text.
33. Drucker, supra note 6.
34. Wal-Mart Stores East, __ N.C. App. at __, 676 S.E.2d at 640 ($4.18 million for the 1998-99 tax period, $4.85 million for 1999-2000, $5.68 million for 2000-01, and $5.15 million for 2001-02). Take Wal-Mart Stores East’s 1998-99 North Carolina tax returns as an example: $3.17 billion in total net income; deducted $1.66 billion in rent paid to W-M REBT as a business expense and subtracted out $1.27 billion in dividend income from W-M PC; under section 105-130.4, it apportioned 4.1625% of these figures to North Carolina (based on the percentage of total business done inside the state). Id. at __ & n.2, 676 S.E.2d at 639-40 & n.2. Thus, Wal-Mart Stores East’s tax return stated that it had earned $78.64 million in North Carolina taxable income, resulting in a total tax of $5.7 million (instead of the $9.9 million it would have owed without the tax avoidance strategy). Id. at
The North Carolina Department of Revenue audited Wal-Mart Stores East’s 1998–99 returns and concluded that the company had underpaid its corporate income taxes. Specifically, the Department of Revenue stated that the income reports of Wal-Mart Stores East, W-M PC, and W-M REBT should all have been combined in order to determine Wal-Mart Stores East’s actual earnings within the state. Combining these three corporate entities resulted in an additional $4 million owed to the state for the 1998–99 tax period. The Department of Revenue also assessed nearly $1.7 million in interest and a $1 million penalty for 1998–99. After completing similar calculations for the 1999–2000, 2000–01, and 2001–02 tax periods, the Department of Revenue ordered a total payment of approximately $27 million.

Wal-Mart Stores East paid the $27 million, but it then filed suit against the North Carolina Secretary of Revenue in March 2006 for a refund pursuant to title 105, section 267 of the North Carolina General Statutes. Wal-Mart Stores East’s complaint alleged that the assessment issued by the Department of Revenue was illegal in that the Secretary had no authority—statutory or otherwise—to force a combination of Wal-Mart Stores East, W-M PC, and W-M REBT. The trial judge granted summary judgment for the state, and Wal-Mart appealed to the North Carolina Court of Appeals. In its May
2009 ruling, the court of appeals found for the state and consequently affirmed the trial court’s decision.43

II. STATUTORY INTERPRETATION OF SECTION 105-130.6

The North Carolina Court of Appeals was undoubtedly struck by the perceived unfairness of a multi-billion dollar corporation using a blatant tax shelter to avoid contributing its share of state taxes. The opinion treated the statutory interpretation of section 105-130.6 as an easy question. Based upon application of statutory construction principles, North Carolina case law, and law from other jurisdictions, the court found that the Secretary had the authority to force a combination of the Wal-Mart corporate entities.44 However, the statutory interpretation question was closer than the court admitted. The court of appeals read the forced combination provision in isolation from the rest of the statute, and the court improperly distinguished the statute’s legislative history and law from other jurisdictions.

A. Competing Interpretations of Section 105-130.6

The relevant language of section 105-130.6 reads as follows:

The net income of a corporation doing business in this State that is a parent, subsidiary, or affiliate of another corporation shall be determined by eliminating all payments to or charges by the parent, subsidiary, or affiliated corporation in excess of fair compensation in all intercompany transactions of any kind whatsoever. If the Secretary 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, the Secretary may require the corporation to file a consolidated return of the entire operations of the parent corporation and of its subsidiaries and affiliates, including its own operations and income. The Secretary shall determine the true amount of net income earned by such corporation in this State. The combined net income of the corporation and of its parent, subsidiaries, and affiliates shall be apportioned to this State by use of the

43. Wal-Mart Stores East, ___ N.C. App. at __, 676 S.E.2d at 634, 654.
44. See id. at __, 676 S.E.2d at 641-47.
WAL-MART STORES EAST, INC.

applicable apportionment formula required to be used by the corporation under G.S. 105-130.4.\footnote{N.C. GEN. STAT. § 105-130.6 (2009) (emphasis added).}

The statutory interpretation issue in Wal-Mart Stores East involved determining under what circumstances the second sentence of section 105-130.6 authorized the Secretary of Revenue to force a combination of individual corporate entities, thereby requiring them to file a consolidated tax return.\footnote{See Wal-Mart Stores East, __ N.C. App. at __, 676 S.E.2d at 641–42.} The state argued that the statute authorized a forced combination in any case where a taxpayer’s “true earnings” were somehow distorted.\footnote{See Wal-Mart Stores East, Inc. v. Hinton, No. 06-CVS-3928, slip op. at 5–6 (N.C. Super. Ct. Dec. 31, 2007), aff'd, __ N.C. App. __, 676 S.E.2d 634 (2009).} The state interpreted “true earnings” expansively, meaning something akin to the amount of income that officials could fairly attribute to activity within North Carolina.\footnote{See id.} Wal-Mart Stores East argued that this standard was too broad and that the statute only authorized forced combination in cases of non-arm’s length dealing.\footnote{Brief for Plaintiff-Appellant, supra note 42, at 8.} Where individual corporate entities conducted business at arm’s length, as the Wal-Mart affiliates had done (by carrying out independent business activities and dealing at fair market prices), the statute did not allow forced combination.”\footnote{Id. at 7–8.} Wal-Mart Stores East pointed out that North Carolina is a “separate return” state where individual companies, even if they are affiliated, file separate returns except in the rarest of circumstances.\footnote{See id. at 9–11.}

In support of its non-arm’s length interpretation, Wal-Mart Stores East argued that the first two sentences of section 105-130.6 were intended to be read together.\footnote{See id.} Specifically, the first sentence allows the Secretary of Revenue to eliminate individual payments from a business’s reported income when corporate affiliates are overpaying each other in order to transfer earnings from North Carolina to a lower-tax state.\footnote{See id. at 9–10.} This situation involves non-arm’s

\begin{footnotes}
\footnotetext[45]{See Wal-Mart Stores East, __ N.C. App. at __, 676 S.E.2d at 641–42.}
\footnotetext[47]{See Wal-Mart Stores East, __ N.C. App. at __, 676 S.E.2d at 642. Arm's length transactions are those "between two unrelated and unaffiliated parties" or "between two parties, however closely related they may be, conducted as if the parties were strangers, so that no conflict of interest arises." BLACK'S LAW DICTIONARY 1635 (9th ed. 2009). Non-arm's length dealing occurs when affiliated parties structure transactions under unequal terms, such as non-market prices. See, e.g., Montgomery Coca-Cola Bottling Co. v. United States, 615 F.2d 1318, 1329–30 (Cl. Ct. Cl. 1980) (describing the "nonarm's-length nature" of rental payments that were "not sufficient to cover the fair rental value" and that had been "fixed by [a] family unit").}
\footnotetext[48]{Brief for Plaintiff-Appellant, supra note 42, at 8.}
\footnotetext[49]{Id. at 7–8.}
\footnotetext[50]{See id. at 9–11.}
\end{footnotes}
length dealing since the transactions are at non-market rates. The second sentence provides similar authority, but allows the Secretary to simply force a combination of the corporate entities, such as when he cannot identify specific instances of non-arm’s length dealing but nevertheless has evidence it is occurring.

Wal-Mart Stores East’s proposed interpretation of section 105-130.6 is illustrated by the following example: Consider a Virginia-based shoe company that has a subsidiary that operates retail shoe stores in North Carolina. If North Carolina has higher tax rates than Virginia, the parent company has an incentive to “sell” its shoes to the North Carolina subsidiary at prices above market rates in order to transfer as much income as possible from North Carolina to Virginia, thereby decreasing its overall taxes. The first sentence of section 105-130.6 would allow the Secretary of Revenue to eliminate individual overpayments from the North Carolina retailer’s tax filings (thus giving it more taxable income in North Carolina). The second sentence would allow the Secretary to force the two companies to file a combined return so that any overpayments are automatically cancelled out by the parent company’s corresponding income received. The second option would be useful when specific instances of overpayment were difficult to identify but when evidence (such as years of surprising business losses for the subsidiary) nevertheless indicated non-arm’s length dealing was occurring. According to Wal-Mart Stores East, however, the state could not force a combination under either option absent evidence of non-arm’s length dealing.

Despite Wal-Mart Stores East’s argument, the court of appeals examined the forced combination provision independent of the first sentence. The court concluded that the second sentence of the statute gives the Secretary of Revenue broad authority to order combined reporting in cases where he determines that a corporation has not reported its “true earnings.” The court noted that no

54. See id. at 10.
55. Id.
56. This discussion is based on a similar example provided in an amicus curiae brief filed in support of Wal-Mart Stores East. See Brief for North Carolina Chamber of Commerce & North Carolina Retail Merchs. Ass’n as Amici Curiae Supporting Plaintiff-Appellant at 7, Wal-Mart Stores East, Inc. v. Hinton, ___ N.C. App. ___, 676 S.E.2d 634 (2009) (No. COA08-450) [hereinafter Amici Curiae Brief] (referencing M.S. Breckenridge, Tax Escape by Manipulations of Holding Company, 9 N.C. L. REV. 189, 190 (1931)).
57. Brief for Plaintiff-Appellant, supra note 42, at 11.
58. See Wal-Mart Stores East, ___ N.C. App. at ___, 676 S.E.2d at 642.
59. Id.
language in the second sentence limits application to "intercompany transactions at amounts other than fair value" (non-arm's length dealing). Thus, the court's interpretation was that the plain language of the statute supported an expansive interpretation of the Secretary's authority. The court stated that the "essential meaning" of the term "true earnings" simply describes the constitutional limits on states taxing multi-state business activity that the U.S. Supreme Court has outlined. The court then rejected any interpretation of "true earnings" limited to arm's length dealing.

The court of appeals correctly stated that plain language interpretations are the preferable approach to statutory analysis. This is because the underlying aim of statutory construction is to determine legislative intent, and when statutory language is clear and unambiguous, courts should assume that the language represents legislative intent. However, context matters when making these determinations. By ignoring the statutory context in which the forced combination language appears, the court disregarded the well-established statutory construction principle of in pari materia. Under in pari materia, segments of a statute should be read holistically where several parts of a statute deal with similar subject matter. Like with

60. Id.
61. See id.
62. Id. at __, 676 S.E.2d at 643 (citing Allied-Signal, Inc. v. Dir., Div. of Taxation, 504 U.S. 768, 772-73 (1992); Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 436-37 (1980)).
63. Id. at __, 676 S.E.2d at 642-43.
66. Diaz v. Div. of Soc. Servs., 360 N.C. 384, 387, 628 S.E.2d 1, 3 (2006) ("When the language of a statute is clear and without ambiguity, it is the duty of this Court to give effect to the plain meaning of the statute, and judicial construction of legislative intent is not required." (citing Burgess, 326 N.C. at 209, 388 S.E.2d at 136)).
68. See Brown v. Flowe, 349 N.C. 520, 524, 507 S.E.2d 894, 896 (1998) ("Our task is to give effect, if possible, to all sections of each statute and to harmonize them into one law on the subject." (citing Williams v. Williams, 299 N.C. 174, 180-81, 261 S.E.2d 849, 854 (1980))); MMR Holdings, LLC v. City of Charlotte, 174 N.C. App. 540, 545, 621 S.E.2d
any form of communication, taking language out of context can produce unintended results. The North Carolina Court of Appeals has consequently stated that "where a literal interpretation of the language of a statute would contravene the manifest purpose of the statute, the reason and purpose of the law will be given effect and the strict letter thereof disregarded." 69

Reading the statute as a whole, it seems reasonable that the second sentence of section 105-130.6 should be considered alongside the first sentence, which is clearly aimed at situations in which corporate affiliates are overpaying each other in order to transfer income to lower-tax states. Under the first sentence, addressing these non-arm's length transactions would prove difficult when the Secretary could not identify specific instances of overpayment. Combined reporting addresses this problem by automatically cancelling out the transfers when the corporate entities are combined together for tax purposes. The fact that "true earnings" is not a defined term in the North Carolina statutes further supports an in pari materia reading. Although the court referenced the U.S. Supreme Court cases Allied-Signal, Inc. v. Director, Division of Taxation70 and Mobil Oil Corp. v. Commissioner of Taxes71 as providing the correct meaning of "true earnings,"72 the term "true earnings" does not appear in either case.73 Hence, the court of appeals was inaccurate in claiming that it was "consider[ing] the meaning of the word or phrase in cases where the word or phrase has been defined."74 While these cases do discuss the constitutional requirements in determining the amount of a multi-state business's earnings that individual states can tax,75 ascribing this concept to the General Assembly's intended meaning of "true earnings" requires

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73. Nor does the term "true earnings" appear in any of the cases to which Allied-Signal and Mobil Oil cite in the portions of these two opinions referenced by the court of appeals. See Allied Signal, 504 U.S. at 772-73; Mobil Oil, 445 U.S. at 436-40.
74. Wal-Mart Stores East, __ N.C. App. at __, 676 S.E.2d at 643 (citing Duke Power Co. v. Clayton, 274 N.C. 505, 513-14, 164 S.E.2d 289, 295 (1968)).
75. See Allied-Signal, 504 U.S. at 772-73; Mobil Oil, 445 U.S. at 436-37.
greater analytical support. Finally, references to "true amount of net income" and "net income" immediately following the forced combination provision in section 105-130.6 suggest that the court's broad definition of "true earnings" is outside the statute's scope.

If the court of appeals wanted to accurately effectuate legislative intent, it would have seriously considered the possibility that the forced combination provision was meant to reinforce the somewhat limited remedy provided by the first sentence of section 105-130.6. Such an analysis would then require examining additional indicators of legislative intent, including the historical context surrounding enactment and the use of similar provisions in other jurisdictions.

The court did address each of these issues, but as described below, it addressed them in an inadequate manner.

B. Legislative History of Section 105-130.6

The court of appeals made no real attempt to examine the legislative history of section 105-130.6. The court's discussion of the legislative history consisted solely of addressing Wal-Mart Stores East's citation of a 1941 law review article that described amendments made to the previous version of the statute. However, a thorough statutory interpretation would have required more detailed analysis. Prior to 1941, the predecessor to section 105-130.6 read as follows:

The net income of a corporation which is a subsidiary of another corporation or closely affiliated therewith by stock ownership shall be determined by eliminating all payments to the parent corporation or affiliated corporations in excess of fair value and by including fair compensation to such foreign

76. The reaction some observers had to the broad way in which the court of appeals defined "true earnings" is noteworthy. See, e.g., KPMG.com, North Carolina: State Appeals Court Upholds Forced Combination of Affiliated Entities, TAXNEWSFLASH-U.S., May 27, 2009, http://us.kpmg.com/microsite/taxnewsflash/2009/May/09242.html ("The appeals court's definition of 'true earnings' leaves taxpayers with some uncertainty.... Applying such a definition of 'true earnings' to determine when a combined return is appropriate provides the state with considerable power.").

77. See In re Banks, 295 N.C. 236, 239, 244 S.E.2d 386, 389 (1978) (listing "the law as it prevailed before the statute, the mischief to be remedied, the remedy, [and] the end to be accomplished" as factors courts should consider in determining legislative intent (quoting State v. Partlow, 91 N.C. 550, 552 (1884))); Morton Bldgs., Inc. v. Tolson, 172 N.C. App. 119, 127, 615 S.E.2d 906, 912 (2005) (recognizing that law from "other jurisdictions" can "be instructive" even if it is "not binding" (citing Virmani v. Presbyterian Health Servs. Corp., 350 N.C. 449, 465, 515 S.E.2d 675, 686 (1999)))).

78. See Wal-Mart Stores East, __ N.C. App. at __, 676 S.E.2d at 644.

79. Id. See infra notes 89-96 and accompanying text for a discussion of the law review article.
corporation for all commodities sold to or service performed for the parent corporation or affiliated corporations. *For the purposes of determining such net income* the Commissioner may, in the absence of satisfactory evidence to the contrary, presume that an apportionment by reasonable rules of the consolidated net income of corporations participating in the filing of a consolidated return of net income to the Federal Government fairly reflects the net income taxable under this chapter, or may otherwise equitably determine such net income by reasonable rules of apportionment of the combined income of the subsidiary, its parent and affiliates or any thereof.80

The "such net income" language seems to reference the first sentence of the statute, indicating that the non-arm's length dealing requirement carried forward to the forced combination provision. Other states still have language similar to this version of the statute, and the courts have read the second sentence as containing a non-arm's length standard.81 Thus, the original purpose of section 105-130.6 was to allow tax officials to address non-arm's length dealing when they had evidence of specific overpayments. They could then determine the correct net income figures either by individually eliminating excess payments or by simply requiring a combined return.

The "true earnings" language was added to the statute in 1941.82 The General Assembly also added further language at this same time, which required a finding that "the business in this State is handled or affected in such manner as to distort or not reflect the true income" in order to authorize a forced combination.83 Therefore, the central issue concerning the statute's legislative history is whether the 1941 amendments were meant to remove the non-arm's length requirement from the forced combination provision. Unlike the court of appeals, the trial judge considered this question, and he found it significant that the amended language did not "carry forward any requirement that the Secretary must first find that there are intercompany transactions in excess of fair compensation."84 Despite the trial judge's conclusion, there is evidence that the forced

81. See *infra* notes 99–109 and accompanying text.
82. Act of Feb. 28, 1941, ch. 50, § 5(f), 1941 N.C. Pub. L. 66, 74 (codified as amended at N.C. GEN. STAT. § 105-130.6 (2009)).
83. *Id.*
combination provision retained a non-arm's length standard. The General Assembly placed limits on tax officials' power by imposing the additional requirement that "the [Secretary] further find[] that the business in this State is handled or affected in such manner as to distort or not reflect the true income," and an independent tax statute predating section 105-130.6 suggests that the "distort" language was itself a reference to non-arm's length dealing. It is likely that the new language was meant to plainly authorize tax officials to force a combination based on circumstantial evidence of non-arm's length dealing (such as a subsidiary consistently losing money while a parent company profited) instead of having to identify specific overpayments. This interpretation would have expanded the Secretary's power, but not to the point of authorizing a combined return whenever he decided that income is fairly attributable to North Carolina. And this authority would have been useful given the asymmetric information between corporations and state officials concerning specific intercompany pricing levels.

The court of appeals' only discussion of legislative history concerned Wal-Mart Stores East's citation to a 1941 North Carolina Law Review article addressing the amendments made to the statute. Wal-Mart Stores East referenced the article in arguing that the current forced combination provision contains a non-arm's length standard. The article stated that

the new [forced combination] provision goes further than simply authorizing specific contracts or credits or charges between parent and subsidiary to be revised or disregarded in determining the latter's taxable income.... [B]ut the new provision will, if valid, authorize consideration of the system's entire income without finding any unfairness or unwarranted

86. See N.C. GEN. STAT. § 105-130.16(b) (2009) ("When... any corporation so conducts its trade or business in such manner as to either directly or indirectly distort its true net income and the net income properly attributable to the State, whether by the arbitrary shifting of income, through price fixing, charges for service, or otherwise... the Secretary may require any facts the Secretary considers necessary for the proper computation of the entire net income and the net income properly attributable to the State... "); see also Brief for Plaintiff-Appellant, supra note 42, at 23–24 (arguing that section 105-130.16 could apply only to non-arm's length transactions); Amici Curiae Brief, supra note 56, at 7–8 (same).
87. See Brief for Plaintiff-Appellant, supra note 42, at 10.
88. See id. at 11.
90. Brief for Plaintiff-Appellant, supra note 42, at 11.
bookkeeping methods in connection with specific intercompany transactions.  

Interestingly, the court of appeals concluded that this language actually cut against Wal-Mart Stores East’s position. The court said the language suggesting that there need not be any “finding [of] unfairness . . . in connection with specific intercompany transactions” supported granting broad authority to the Secretary of Revenue whenever a company’s income appears unfairly distorted. The article, however, is consistent with Wal-Mart Stores East’s interpretation of the statute. Under the amended statute, tax officials would be able to intervene based on circumstantial evidence of non-arm’s length dealing even though they were unable to identify individual, non-arm’s length transactions (i.e., “specific intercompany transactions”). Further, the previous paragraph of the article refers to instances where “it can be shown that over a long period of years the [corporate] system as a whole has earned money while the subsidiary operating in this state, though doing a substantial business with the system and the public, has nominally earned none.” Such an earnings differential is the very type of evidence that would indicate non-arm’s length dealing because transactions under nonmarket prices would lead to disproportionate earnings between affiliates. The Secretary of Revenue would be able to deal with these instances of non-arm’s length dealing in the aggregate through forced combination even though he had not identified specific, non-arm’s length transactions. At the very least, the court of appeals was incorrect to assert that Secretary Hinton’s actions were “exactly the type of example noted in the [North Carolina Law Review] article as a reason for enacting the second sentence of the statute.”

Finally, recent legislative history may support Wal-Mart Stores East’s position. In 2007, the General Assembly amended the state tax code to include dividend payments in the taxable income of captive REITs. The legislature’s action was in response to captive REIT tax avoidance schemes, and Wal-Mart Stores East argued that the

92. Wal-Mart Stores East, ___ N.C. App. at __, 676 S.E.2d at 644.
93. Id. (quoting A Survey of Statutory Changes, supra note 91, at 535).
94. See Brief for Plaintiff-Appellant, supra note 42, at 11.
95. A Survey of Statutory Changes, supra note 91, at 534.
96. Wal-Mart Stores East, ___ N.C. App. at __, 676 S.E.2d at 644.
amendment demonstrated the legislature’s belief that section 105-130.6 did not authorize the Department of Revenue to address captive REIT tax avoidance strategies. The implication is that the General Assembly would not have passed a new law if the Secretary of Revenue already had the requisite statutory authority.

C. Other Jurisdictions’ Forced Combination Provisions

In addition to its inadequate legislative history analysis, the court distinguished legal authority from other jurisdictions that suggested Wal-Mart Stores East’s construction of section 105-130.6 was, in fact, correct. The forced combination statutes in Georgia and Massachusetts both contain essentially the same language as the original version of section 105-130.6. The statutes provide state tax officials authority to either “eliminate all payments ... in excess of fair value” or to determine taxes based on “combined income.” Interpretations of each of these statutes support the conclusion that the original purpose of the section 105-130.6 forced combination provision was to address instances of non-arm’s length dealing. Both a Court of Appeals of Georgia opinion and the current Georgia

98. Wal-Mart Stores East argued:

Early in 2006 the General Assembly was told that the law applied exactly as Plaintiff is contending in this matter and that legislative action was needed to change the law effectively to achieve the result sought by Defendant here. The legislature did ultimately take action and amended the statutes, effective January 1, 2007.

Brief for Plaintiff-Appellant, supra note 42, at 27–28 (citing N.C. GEN. STAT. § 105-130.12 (2009)). The counterargument is that the General Assembly simply wanted to provide the Department of Revenue an additional tool to address similar tax avoidance schemes (the name of the amendment was “Alternative for Addressing a Corporation’s Attempt to Avoid State Taxes Through the Use of a REIT”). See Act of July 30, 2007, ch. 323, § 31.18(e), 2007 N.C. Sess. Laws at 941. The legislation clearly stated that it was not meant to undermine the Department’s power under section 105-130.6. See § 31.18(e).


100. MASS. ANN. LAWS ch. 63, § 39A.
101. GA. CODE ANN. § 48-7-31(e).

[i]n our opinion the two sentences must be read together, the second as limited by the first, which as a mandatory rule has priority. Thus, in order to exercise the discretion under the second rule the Commissioner must find that the income of the taxpayer cannot be adjusted in the manner first prescribed. To hold otherwise would reflect a determination that the second sentence gives him an unbridled discretion to resort to the unitary theory even though the taxpayer has done
Code of Regulations state that forced combination is available only when non-arm's length dealing has occurred. Similarly, the Massachusetts Supreme Judicial Court interpreted its state's statute to require non-arm's length dealing in *Polaroid Corp. v. Commissioner*.

The court observed that "words of a statute must be construed in association with other statutory language and the general statutory plan" and that "[m]ost of § 39A concerns the problem of . . . less than arm's length transactions between affiliates." The North Carolina Court of Appeals distinguished the Georgia and Massachusetts statutes on the grounds that their forced combination provisions do not reference "true earnings." This distinction, however, is unconvincing absent evidence that the General Assembly intended the "true earnings" language to expand the scope of North Carolina's forced combination provision beyond non-arm's length dealing.

Moreover, the North Carolina Court of Appeals made no mention of the other jurisdictions' statutes cited by Wal-Mart Stores East in its appellate brief, including the Florida forced combination statute. The Florida statute permits forced combination "if the filing of separate returns . . . would improperly reflect the taxable incomes of such corporations." Supporting Wal-Mart's statutory argument is the fact that Florida state officials have interpreted this language as requiring a finding of non-arm's length dealing before the Commissioner could force a combination. Importantly, Florida requires non-arm's length dealing even given its broad standard of "improperly reflect[ing] the taxable incomes" and the lack of any everything the law requires, or even though the Commissioner could adjust the return to reflect what the law requires.

Id.

103. GA. COMP. R. & REGS. 560-7-8.07(3) (2009) ("[I]f it is found that affiliates are in fact dealing at arms length, operating, buying and selling, and otherwise dealing with each other as if they were not affiliated, consolidation will not apply.").

104. See Brief for Plaintiff-Appellant, supra note 42, at 14 (discussing Georgia case law and regulations regarding when forced combination is permissible).

105. 472 N.E.2d 259, 265 (Mass. 1984) (holding that non-arm's length dealing must exist for the Commissioner to require a forced combination).

106. Id. at 264.


110. FLA. STAT. ANN. § 220.131(2).

111. See FLA. ADMIN. CODE ANN. r. 12C-1.0131(2) (2009).

112. FLA. STAT. ANN. § 220.131.
statutory language referencing overpayment between corporate affiliates. Florida therefore retains a non-arm's length standard despite having a statute that conceivably could be interpreted more broadly (much like the “true earnings” language in section 105-130.6).

Even if the above criticisms did not necessarily compel a ruling in favor of Wal-Mart Stores East, a complete treatment of the relevant statutory interpretation principles presents strong justification for its argument—justification the court of appeals should have addressed. Instead, it seems that the court conducted an incomplete statutory interpretation due to uncertainty about the result under a more comprehensive analysis. This hypothesis becomes more likely when one considers that tax statutes are to be strictly construed against the state when any ambiguity exists. Thus, underlying the court’s incomplete analysis is the inability of state tax statutes to respond to new and evolving corporate tax avoidance strategies. When taxpayers structure transactions to avoid taxation, the state can attempt to interpret existing law to cover such behavior or else the legislature must amend the tax statutes simply to disallow the tax benefit going forward. Wal-Mart Stores East demonstrates that expansive statutory interpretation can sometimes allow the state to successfully address tax avoidance. Liberally construing existing statutes, however, may require misapplication of legal principles and raise the consequent risk of setting improper precedent. Future courts may rely on such decisions as a model for similar statutory interpretations; such reliance would lead to similarly incomplete analyses and the possibility of failing to effectuate legislative intent.


114. While reading “true earnings” in isolation from the rest of section 105-130.6 may confer the proper government authority in this case, similar statutory readings may undermine appropriate state intervention by failing to consider a law’s broader, contextual purpose. Alternatively, incomplete statutory interpretation may unreasonably expand government power beyond what would have been necessary to address a taxpayer’s actions. For instance, the court of appeals’ interpretation of the “true earnings” language could be read as allowing state officials broad power to force combination whenever they conclude corporations’ activities do not yield a “fair” determination of income. See KPMG.com, supra note 76 (“The appeals court’s definition of ‘true earnings’ leaves taxpayers with some uncertainty . . . . Applying such a definition of ‘true earnings’ to determine when a combined return is appropriate provides the state with considerable power.”). Such powers could extend beyond application of the anti-tax avoidance
III. ANTI-TAX AVOIDANCE PUBLIC POLICY AND THE APPLICABLE JUDICIAL DOCTRINES

Although the court of appeals’ statutory interpretation analysis was incomplete, public policy supports the court of appeals’ ruling regarding the Secretary of Revenue’s authority under section 105-130.6. Limiting the type of tax avoidance attempted by Wal-Mart protects state revenues, provides for simpler tax law, promotes fairness between individual and corporate taxpayers, and promotes economic efficiency. However, North Carolina courts should utilize specific anti-tax avoidance doctrines in future cases instead of relying on incomplete statutory interpretation to justify intervention by the Secretary of Revenue. Anti-tax avoidance judicial doctrines permit officials to disallow tax benefits resulting from transactions done solely to reduce tax liabilities and thus lacking independent economic substance. The doctrines can therefore be applied more broadly than the typical, specific tax statutes. Utilizing these doctrines will allow the state to more fully achieve anti-tax avoidance policy benefits, and it will protect the legal consistency of the relevant jurisprudence.

A. Policy Benefits of Limiting Tax Avoidance

The tax avoidance literature makes clear that limiting the type of behavior exhibited in Wal-Mart Stores East yields important policy benefits. In tax law, the following scenario is quite common: (1) legislature passes tax provision; (2) taxpayers alter behavior to circumvent the intent of tax provision; (3) legislature recognizes the lost revenues and passes a new tax provision to capture the behavior; (4) repeat the first three steps. Anti-tax avoidance policies attempt to break this cycle by limiting taxpayers’ ability to carry out step two and thereby circumvent the tax law. This might be done by broadly interpreting tax statutes (as the court of appeals did in Wal-Mart Stores East) or by giving courts the authority to look at the overall purpose of the taxpayer’s transaction and not just its rigid

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doctrines discussed in Part III.B to situations in which taxpayers structure dealings that have non-tax benefits but in which income is nonetheless transferred out of North Carolina.

115. Note, however, that statutory codification of the doctrines is itself an option. See infra note 159 and accompanying text.

116. See Yin, supra note 2, at 1452 (referencing the process of addressing the “unintended interplay of intricate rules ... through the addition of yet more intricate rules”).

117. See Glickman & Calhoun, supra note 17, at 1181–89; Weisbach, supra note 17, at 88–89; George Zeitlin, United States of America, in TAX AVOIDANCE, TAX EVASION, supra note 1, at 91, 95.
formulation. Clearly, preventing tax avoidance helps maximize government revenues.\textsuperscript{118} Even when the legislature eventually responds to the tax avoidance, the government has already lost revenues that should have been collected before the intervention.\textsuperscript{119} Similarly, anti-tax avoidance public policies provide for simpler tax codes.\textsuperscript{120} If tax law can be applied more broadly, then there is less need for legislatures to go back and add new, technical tax provisions whenever taxpayers discover new ways to circumvent the law. Simpler tax laws allow lawmakers to focus on more important issues, and they facilitate greater public understanding of the tax code.

Additionally, anti-tax avoidance policies promote fairness across the tax system, including fairness between individual and corporate taxpayers. Limiting taxpayers' ability to avoid taxes meant to apply to them helps ensure that everyone is paying his fair share. This result may also increase overall compliance and respect for the law more generally\textsuperscript{121} as citizens come to perceive the tax code as a more equitably administered set of laws. Also, it should come as no surprise that corporations are more skilled than most individuals at crafting transactions in ways that avoid tax liability. Financial institutions earn millions of dollars designing tax avoidance strategies and selling them to interested corporations.\textsuperscript{122} Largely due to corporate success in avoiding taxes, the effective state corporate tax rate has decreased over the past twenty years from 6.7% in the 1980s to about 5% today.\textsuperscript{123} Corporations' share of total state tax revenues has fallen as compared to the percentage paid by individuals.\textsuperscript{124} For instance, the share of total state tax revenues paid by corporations fell from 8.7%
in 1991 to 6.6% in 2001 even though corporate profits doubled. In North Carolina, the portion of the state's total tax revenues derived from corporate income tax fell from 8.7% in 1979 to 4.3% in 2002. While some of the change in proportional tax revenues is due to purposeful economic incentives formulated by state policymakers and other economic factors, corporate tax avoidance strategies have had a significant impact. Thus, limiting tax avoidance can help promote fairness between corporations and individuals and can ensure that effective tax rates are more reflective of legislative intent.

Finally, anti-tax avoidance public policies promote economic efficiency. Efficiency losses occur when tax policy causes individuals and businesses to make altered choices that result in outcomes no longer properly aligned with market-based preferences. Anti-tax avoidance policies disincentivize (at least to some degree) taxpayers from changing their behaviors in response to changes in tax laws. In a 2002 journal article, Professor David A. Weisbach examined the impact of anti-tax avoidance judicial doctrines on economic efficiency. Weisbach concluded that these doctrines have the ability to increase overall economic efficiency by "reducing the marginal elasticity of taxable income." Basically, anti-tax avoidance policies make it more difficult to change taxable income into nontaxable income through altered behavior, and this result reduces behavioral

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125. Kiely, supra note 124 (citing the U.S. Commerce Department's Bureau of Economic Analysis).
126. LAV ET AL., supra note 124, at 19.
127. In recent years, North Carolina has offered sizeable state and local tax incentives to several corporations—including Dell and Apple—in order to attract new business to the state. See Sharif Durhams & Kerry Hall, N.C. Offers Incentives for Dell Plant, CHARLOTTE OBSERVER, Nov. 5, 2004, at 1A; Mark Johnson, Senate OKs Apple Tax Break; Final Vote Monday, NEWS & OBSERVER (Raleigh, N.C.), May 29, 2009, at 5B. North Carolina's use of corporate incentives has not been without controversy. See, e.g., Jonathan B. Cox, Incentives: Do They Help or Hurt N.C.'s Brand?, NEWS & OBSERVER (Raleigh, N.C.), Oct. 21, 2007, at 25A; Kerry Hall, Group Sues N.C. over Dell Incentives, CHARLOTTE OBSERVER, June 24, 2005, at 1D.
129. See HARVEY S. ROSEN, PUBLIC FINANCE 304 (7th ed. 2005).
130. See infra Part III.B.
131. Weisbach, supra note 17, at 88.
132. Id.
133. Id. at 94–95.
changes and therefore minimizes the distortionary effects of a tax system:

[The reduced elasticity of taxable income] makes the tax system more efficient in the sense that a given tax rate will induce fewer changes in behavior and raise more revenue. This is analogous to the familiar notion that taxing items with lower elasticities creates lower deadweight loss. (In fact, we can show under certain assumptions that the additional tax revenue from the change in elasticity is directly proportional to the deadweight loss in the system. The intuition is, as just stated, that the tax system becomes hard to avoid so that the deadweight loss from shifting behavior is smaller and, correspondingly, the tax revenues from a given tax are higher.)

Weisbach also examined the potential efficiency losses that might result from anti-tax avoidance policies, but he concluded that policymakers could maximize the net (efficiency) benefits through proper implementation.

B. Anti-tax Avoidance Judicial Doctrines

The benefits of anti-tax avoidance public policies suggest that the court of appeals was correct in upholding the Secretary of Revenue’s actions. However, underlying the court’s incomplete statutory analysis of section 105-130.6 is the inability of state tax statutes to respond to new and evolving corporate tax avoidance strategies. Wal-Mart Stores East therefore demonstrates the need for North Carolina courts to apply the anti-tax avoidance doctrines commonly used by federal courts. In a world where accounting firms can make millions selling sophisticated tax schemes to large corporations, North Carolina needs to fully utilize the legal strategies available to limit egregious acts of tax avoidance—including applying anti-tax avoidance judicial doctrines where appropriate. Tax officials may not always be able to identify statutes that grant the specific authority necessary to address tax avoidance. Where officials can identify

134. Id. at 98 (footnote omitted).
135. Id. at 113.
136. For a discussion of federal usage of anti-tax avoidance judicial doctrines, see infra notes 143–49 and accompanying text.
137. Cf. Drucker, supra note 6 (explaining that Ernst & Young sought to market its captive REIT strategy to large-scale retailers and banks because, like Wal-Mart, these companies “have branches in many states and often are liable for lots of state-level corporate tax”).
possible authority, the courts may be forced to engage in incorrect statutory interpretation to uphold their actions, running the risk of setting bad precedent in the process. The anti-tax avoidance doctrines work more broadly by enabling tax officials to disallow tax benefits resulting from transactions designed solely to reduce tax liabilities and that lack an independent economic purpose. Consequently, state officials are able to intervene even when transactions technically meet the letter of the tax law, and courts are able to uphold their intervention. Furthermore, these doctrines function preemptively by sending important signals to tax planners that certain levels of tax avoidance will not be allowed. Despite these benefits, North Carolina appellate courts have made no discernible effort to employ anti-tax avoidance judicial doctrines.

The anti-tax avoidance judicial doctrines have a variety of names, specifically substance over form, business purpose doctrine, economic substance doctrine, sham transaction doctrine, and step transaction doctrine. The doctrines serve essentially the same purpose: allowing courts to uphold state intervention when a taxpayer's conduct has technically produced tax benefits but the conduct was undertaken with that sole purpose in mind. In some cases, the individual doctrines are indistinguishable, and application of one produces the same result as application of another.

The anti-tax avoidance doctrines are well-established in federal case law. The Fourth Circuit Court of Appeals case *Rice's Toyota World, Inc. v. Commissioner* provides one example. In *Rice's Toyota World, Inc. v. Commissioner* the court upheld the intervention of state officials when a taxpayer's conduct was undertaken with the sole purpose of reducing tax liabilities. The doctrines are well-established in federal case law, and courts have consistently upheld the intervention of state officials when taxpayers have engaged in transactions that lack an independent economic purpose.

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138. See supra note 114 and accompanying text.
139. Yin, supra note 2, at 1452.
140. Glickman & Calhoun, supra note 17, at 1183. Each doctrine employs a slightly different rationale. For instance, the economic substance doctrine broadly allows "a court to deny the tax benefits achieved by a business transaction where the transaction itself lacks any economic benefit without regard to the tax benefits." *Id.* The substance over form doctrine allows tax officials and courts to evaluate "the tax results of a particular transaction . . . based on the substance of what took place rather than the formal steps the taxpayer took." *Id.* at 1185.
141. See Zeitlin, supra note 117, at 91, 95.
142. For example, a transaction lacking any "economic substance" could also be labeled as lacking any true "business purpose." Tax officials could therefore intervene under both the economic substance and business purpose doctrines. See Glickman & Calhoun, supra note 17, at 1189.
143. 752 F.2d 89 (4th Cir. 1985).
144. For additional examples of federal application of the doctrines, see ACM P'ship v. Comm'r, 157 F.3d 231, 245, 263 (3d Cir. 1998) (applying the economic substance doctrine to disallow tax benefits from a corporate tax shelter based on a partnership agreement between Colgate-Palmolive and an untaxed business entity); Lerman v. Comm'r, 939 F.2d 44, 45–47, 56 (3d Cir. 1991) (applying the sham transaction doctrine to disallow a tax
Toyota World, an automobile dealer employed a tax avoidance strategy involving a computer purchase-and-leaseback transaction. The automobile dealer purchased a $1.5 million computer system from a seller and immediately leased the computer back to the seller; the seller then subleased the computer system to another party. Although Rice’s Toyota World never had any intention of using the computer system, it benefited from depreciation deductions on the asset and thus lowered its overall taxes. The Fourth Circuit applied the sham transaction doctrine and upheld the IRS’s disallowance of the depreciation deductions. The court found that Rice’s Toyota World “did not have profit motivation apart from tax benefits” and that “the transaction lacked economic substance.” As Rice’s Toyota World demonstrates, these judicial doctrines allow governments to obtain more effectively the benefits of anti-tax avoidance public policy. When a taxpayer structures a transaction that technically circumvents a tax statute (even though the legislature meant to tax the activity), officials can disallow the tax savings if the transaction was designed with no economic rationale but to avoid taxes.

Of course, the anti-tax avoidance doctrines present some potential problems in addition to their benefits. The most significant critique of the doctrines is that they can decrease predictability for taxpayers. Taxpayers who structure transactions according to the plain language of statutory law may nonetheless be penalized. This uncertainty may prove harmful for businesses and individuals that plan for one result, only to have a notice of tax deficiency filed against them. There may even be a chilling effect as businesses and individuals steer clear of legal, wealth-producing transactions for fear
that the tax benefits may eventually be disallowed.\textsuperscript{152} Many individuals structure transactions in ways meant to avoid taxes,\textsuperscript{153} and widespread enforcement could lead to significant increases in tax litigation. This outcome raises judicial economy concerns.\textsuperscript{154} Increased judicial discretion is also a concern because application of the doctrines necessarily involves courts determining when actions have independent economic substance and when they do not.\textsuperscript{155}

Such criticism of the anti-tax avoidance judicial doctrines is well-founded. Governments, however, can limit these concerns by restricting application to the most egregious cases.\textsuperscript{156} Taxpayers who structure transactions with literally zero economic purpose other than to avoid taxes and who manage to keep significant funds from the treasury would face enforcement, but others would not.\textsuperscript{157} While making the egregious/non-egregious distinction may be difficult in close cases, the limitation improves predictability to a large degree. It also puts tax planners on notice that the most blatant acts of tax avoidance will not stand.\textsuperscript{158}

The fact that other states successfully employ the anti-tax avoidance doctrines further demonstrates their usefulness. Some legislatures have even passed statutes authorizing tax officials to base tax assessments upon the doctrines (thereby allowing the courts to uphold these rulings).\textsuperscript{159} In reality, any state could properly apply

\begin{itemize}
\item \textsuperscript{152} Jay A. Soled, Use of Judicial Doctrines in Resolving Transfer Tax Controversies, 42 B.C. L. REV. 587, 614 n.119 (2001) ("[L]iberal use of the step transaction doctrine could have a Draconian chilling effect in [the] area of estate planning.").
\item \textsuperscript{153} See generally Yin, supra note 2 (describing the $300–$350 billion annual tax gap in the United States).
\item \textsuperscript{154} See Alexandra M. Walsh, Note, Formally Legal, Probably Wrong: Corporate Tax Shelters, Practical Reason and the New Textualism, 53 STAN. L. REV. 1541, 1545 (2001) (listing "judicial activism" as one concern in applying anti-tax avoidance judicial doctrines).
\item \textsuperscript{155} Id.
\item \textsuperscript{156} Id.
\item \textsuperscript{157} See Frank Lyon Co. v. United States, 435 U.S. 561, 583–84 (1978) ("[W]hen there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties." (emphasis added)).
\item \textsuperscript{158} Id., supra note 2, at 1452 ("[Anti-tax avoidance standards] might be an important signal to tax advisors that they should not be giving counsel based on overly literal interpretations of the law.").
\item \textsuperscript{159} The Massachusetts legislature adopted a broad sham transaction statute in 2003. See MASS. ANN. LAWS ch. 62C, § 3A (LexisNexis 2008); Glickman & Calhoun, supra note
these doctrines given the reliance on federal income taxes in determining state taxable income. Because federal income tax calculations—based on federal tax law—provide the starting point for most taxable income calculations, federal tax principles are properly applied to state-level judicial determinations.\textsuperscript{160} Several state courts have accepted this rationale by applying the anti-tax avoidance doctrines to state taxes completely unrelated to any federal tax calculations.\textsuperscript{161} Regardless of the means by which they are applied,

\textsuperscript{17} at 1191–92 (recounting the Massachusetts legislature’s enactment of the sham transaction statute). Ohio and New Hampshire have enacted similar statutes. See OHIO REV. CODE ANN. § 5703.56 (LexisNexis 2008); N.H. REV. STAT. ANN. § 21-J:38-a (LexisNexis 2008); Glickman & Calhoun, \textit{supra} note 17, at 1191–92 (noting that Ohio and New Hampshire enacted legislation authorizing their respective tax commissioners to disallow sham transactions). Ohio’s statute reads:

The tax commissioner may disregard any sham transaction in ascertaining any taxpayer’s tax liability. Except as otherwise provided in the Revised Code, with respect to transactions between members of a controlled group, the taxpayer shall bear the burden of establishing by a preponderance of the evidence that a transaction or series of transactions between the taxpayer and one or more members of the controlled group was not a sham transaction. Except as otherwise provided in the Revised Code, for all other taxpayers, the tax commissioner shall bear the burden of establishing by a preponderance of the evidence that a transaction or series of transactions was a sham transaction.

§ 5703.56(B).

\textsuperscript{160} For one example of this approach, see Glickman & Calhoun, \textit{supra} note 17, at 1210. Note that states largely agree that they can apply the judicial doctrines to adjust a taxpayer’s federal income tax calculations when providing a federal income tax figure is one step in a state tax calculation. \textit{Id.} at 1206–07. The North Carolina Department of Revenue has even taken this approach in administrative hearings:

[T]he Secretary has authority to make an \textit{independent} determination of the taxpayer’s federal taxable income under the Code and is not limited to accepting the taxpayer’s federal return as filed or even as accepted by the IRS. Included in this authority to determine federal taxable income is the power to use equitable doctrines developed at the federal level, such as the step transaction doctrine, for example. Furthermore, use of these doctrines is implicit in the use of federal taxable income as the starting point for State net income. I have previously held that: “Federal taxable income provides the starting point for the calculation of State net income. Therefore, all federal statutes, doctrines and case law relevant to determining federal taxable income are available for use by the state.”


\textsuperscript{161} Glickman & Calhoun, \textit{supra} note 17, at 1207–11; see, e.g., TD Banknorth, N.A. v. Dep’t of Taxes, 2008 VT 120, ¶¶ 24–26, 967 A.2d 1148, 1157–58 (explicitly adopting the economic substance doctrine in Vermont and applying the doctrine in disallowing classification of holding companies as separate entities for tax purposes); see also infra
states have become increasingly aggressive in using these doctrines over the last decade.\textsuperscript{162} And there is evidence that the use of the doctrines on the state level as a means to prevent corporate tax avoidance will continue to spread.\textsuperscript{163}

Notably, other states have applied the doctrines in cases similar to \textit{Wal-Mart Stores East}. In \textit{HMN Financial, Inc. v. Commissioner},\textsuperscript{164} Minnesota tax officials disallowed deductions for transactions comprising a captive REIT structure similar to the Wal-Mart REIT strategy.\textsuperscript{165} The Minnesota Tax Court upheld the state’s actions, concluding that the scheme lacked any economic substance and should therefore be disallowed.\textsuperscript{166} The court stated that “when the REIT transactions are viewed as a whole, the only genuine reason for the captive REIT transactions was to avoid Minnesota tax.”\textsuperscript{167} Similarly, in \textit{In re Talbots, Inc.},\textsuperscript{168} a New York appellate tax court affirmed the forced combination of Talbots (a women’s clothing retailer) with a subsidiary because the subsidiary itself did not have any non-tax avoidance purpose.\textsuperscript{169} Talbots had created a licensing agreement with a Chicago-based subsidiary under which Talbots paid the subsidiary excessive royalties so that it could transfer income from New York in order to decrease its New York franchise tax.\textsuperscript{170} The subsidiary did not have any employees,\textsuperscript{171} and the court concluded that it seemed to have been created solely to limit Talbots’ tax liabilities.\textsuperscript{172}

An analysis similar to \textit{HMN Financial} or \textit{Talbots} would have worked equally well in \textit{Wal-Mart Stores East}. In fact, the trial judge in \textit{Wal-Mart Stores East} seemed to apply the economic substance doctrine in his decision. In granting summary judgment for the state, Judge Horton observed:

Plaintiffs [Wal-Mart Stores East] do not deny the facts demonstrating the circular journey taken by the “rents” paid by these plaintiffs, but contend that on each leg of the journey

\begin{notes}
\item See Glickman & Calhoun, \textit{supra} note 17, at 1188–97.
\item See id. at 1182.
\item No. 7911-R, 2009 WL 1506929 (Minn. Tax May 27, 2009).
\item Id. at *18.
\item Id. at *25.
\item Id. at *22.
\item Id. at *43–45.
\item Id. at *11.
\item Id. at *6.
\item Id. at *45.
\end{notes}
plaintiffs were only taking advantage of a lawful deduction afforded them by then-existing tax law. Such a piecemeal approach exalts form over substance, however.... There is no evidence in this record of any economic impact (apart from the obvious state tax savings) of the transaction to plaintiffs. ....

... [T]here is no evidence that the rent transaction, taken as a whole, has any real economic substance apart from its beneficial effect on plaintiffs' North Carolina tax liability. It is particularly difficult for the court to conclude that rents were actually "paid," when they are subsequently returned to the payor corporation.173

Following the trial court decision, some commentators even concluded that Judge Horton had applied an anti-tax avoidance doctrine in ruling against Wal-Mart Stores East.174 The North Carolina Court of Appeals, however, completely ignored Judge Horton's "economic substance" language and relied solely on straightforward statutory interpretation, even though Wal-Mart Stores East addressed the economic substance issue in its appellate brief and presented arguments about whether the REIT truly had any independent economic substance.175 The court of appeals' decision was unfortunate since it is likely that applying an anti-tax avoidance judicial doctrine could have easily decided the case.176 Wal-Mart Stores East formulated the multi-million dollar captive REIT structure for the sole purpose of avoiding North Carolina taxes. There were no independent economic benefits to the scheme because rent paid to W-M REBT was cycled

174. See, e.g., HMN Fin., Inc. v. Comm'r, No. 7911-R, 2009 WL 1506929, at *22 (Minn. Tax May 27, 2009) (citing the Wal-Mart Stores East trial court opinion as an example of a court applying an anti-tax avoidance doctrine); Glickman & Calhoun, supra note 17, at 1211 n.159 (same).
175. Brief for Plaintiff-Appellant, supra note 42, at 18–22.
176. Wal-Mart Stores East argued that the captive REIT structure had independent economic substance. Id. However, its stated arguments were unconvincing and essentially pointed out that W-M REBT and Wal-Mart Stores East were "separate and distinct entities" under the law. Id. at 19. Wal-Mart Stores East stated that the entities had different legal rights and responsibilities (including W-M REBT's right to collect rent and ability to use the land as collateral), entered into numerous contracts together, and engaged in fair (not sham) rental payments. Id. at 19–21. The issue, however, is whether Wal-Mart's creation of these entities served any purpose beyond state tax avoidance. As Judge Horton and others (for example, Drucker, supra note 6) pointed out, Wal-Mart's REIT corporate structure appeared to be nothing more than a multi-million dollar tax avoidance scheme.
right back to Wal-Mart Stores East in the form of dividends.  

Thus, the Secretary of Revenue could properly ignore the tax deductions that Wal-Mart Stores East claimed for rental payments to W-M REBT under one of the anti-tax avoidance doctrines. Forced combination of the individual corporate entities would not have even been necessary (though, as Talbots reveals, it certainly would have been an option). At the very least, the court of appeals could have offered the anti-tax avoidance judicial doctrines as additional support for its statutory interpretation conclusion—using the doctrines to allow state intervention in close questions of statutory authority.

CONCLUSION

Although the North Carolina Court of Appeals reached the correct result from a public policy standpoint in Wal-Mart Stores East, it did so after conducting an incomplete statutory analysis. The court of appeals’ incomplete statutory interpretation reveals the inability of statutes to reliably address instances of tax avoidance. North Carolina courts must be willing to apply specific anti-tax avoidance judicial doctrines in future cases of egregious tax avoidance. Anti-tax avoidance doctrines work more broadly than straightforward statutory interpretation by disallowing tax benefits that result from taxpayers conducting transactions solely to reduce tax liabilities and thus lacking independent economic purpose. Applying the doctrines helps achieve important policy benefits, including protecting state revenues, providing for simpler tax law, promoting fairness between individual and corporate taxpayers, and promoting economic efficiency. Additionally, limiting application to egregious cases of misconduct would largely avoid the negative consequences of the doctrines. Applying one of the anti-tax avoidance doctrines in Wal-Mart Stores East would have protected the logical consistency of North Carolina statutory interpretation jurisprudence and would have disincentivized future acts of tax avoidance. Because the Secretary of Revenue will not always be able to find a specific statutory provision under which to attack corporate tax avoidance behavior, the courts must be willing to apply the judicial doctrines in future cases if North Carolina is to fully achieve the benefits of anti-tax avoidance public policy.

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177. See supra notes 27-34 and accompanying text (providing background discussion of Wal-Mart's captive REIT tax avoidance strategy).