Wal-Mart ruling makes the state less attractive

A pending bill in the N.C. General Assembly announces the goal of “reducing uncertainty” in how multistate corporations determine what amount of their income is subject to tax in North Carolina. This is an admirable goal. Taxpayers deserve certainty when it comes to calculating their tax obligations.

Unfortunately, a recent decision by the state Court of Appeals undermines the General Assembly’s goal. While the decision reached the right result, it did so for the wrong reasons, and in the process introduced further uncertainty into North Carolina’s already-complicated corporate tax system.

The case involved a complex scheme by Wal-Mart to reclassify its state tax liability. Wal-Mart tried to do this by transferring all of its North Carolina stores into a Delaware real estate investment trust. The properties were then leased back to the trust from a Wal-Mart subsidiary.

Why do this? Because Delaware imposes practically no tax on real estate investment trusts. Therefore—Wal-Mart escaped tax on the “rents” received by the trust. Meanwhile, the operating company was able to deduct the “rents” it paid to the trust, thereby reducing North Carolina taxes. The bottom line was that, by moving the stores to the Delaware trust, Wal-Mart reduced its North Carolina taxes by about $24 million over a five-year period.

Clearly, the transfer of the stores had no business purpose other than to avoid state taxes. As such, it was a tax sham and should have been struck down for this reason. The Court of Appeals, however, declined to decide the case on the straightforward basis that Wal-Mart’s purpose in transferring its stores was tax avoidance. Instead, the Court ruled against Wal-Mart based on an interpretation of the North Carolina corporate tax statutes that significantly expands the Department of Revenue’s authority to require affiliated entities (like the real estate trust and the operating company) to combine their income for tax purposes.

In North Carolina, separate entities (even if affiliated) generally must file separate tax returns. According to the Court’s decision, however, any time a parent company owns a subsidiary, the “Department of Revenue has the authority to require them to combine their income for tax purposes. The problem is that the Court gave no clear guidance, and there is none in the statutes, as to when the Department of Revenue will exercise its new-found authority.

Compounding this uncertainty is the fact that until instructed otherwise by the Department of Revenue, corporate taxpayers are required as a matter of statute to file separate returns for separate entities. By the time a corporation receives the instruction that it must file a combined return for multiple entities, the corporation may be subject to interest and penalties, as Wal-Mart was to the tune of over $4 million.

North Carolina has made considerable efforts to make the state a more attractive home for businesses. These efforts include the creation of the N.C. Business Court, which has heard consistent and well-reasoned opinions, as well as a current bill in the General Assembly to reduce the corporate tax rate. But businesses seek certainty. The uncertainty created by the Court’s decision and the Wal-Mart case undermines the efforts to attract and retain businesses in North Carolina. Andrew Halle is an assistant professor at Elon University School of Law and a member of The Business Journal’s Editorial Board of Contributors.