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ALABAMA AND NORTH CAROLINA COURTS RULE FOR TAXPAYERS CHALLENGING NEXUS FOR LOCAL TAXES AND AUTOMATIC PENALTIES

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Alabama – Intrastate Taxpayer Nexus With Local Jurisdictions

The Alabama Administrative Law Division (the "ALD") recently addressed the contacts with a local jurisdiction necessary to sustain a duty on an intrastate taxpayer to collect local sales/use taxes in *Cohens Elecs. & Appliances, Inc. v. Ala. Dep't of Revenue* (Admin. Law Div. July 12, 2011). The decision is instructive of the limited protection afforded by the Commerce Clause of the U.S. Constitution, the low threshold necessary to establish Due Process Clause nexus, and the higher protections often provided by state law.

Cohens Electronics & Appliances, Inc. (the "Taxpayer"), operated a retail store in Montgomery, Alabama. The Taxpayer did not have a store or other physical facility outside Montgomery but did have repairmen that made service calls and repaired the electronics and appliances previously sold to its customers, including those customers residing outside Montgomery. The repairmen were sometimes required to provide a new part or parts to complete their repairs. In those cases, the Taxpayer would issue an invoice that separately stated the charge for the repair part(s) and the service charge. The Taxpayer did not charge sales tax on the parts it sold and was therefore issued an assessment. The Taxpayer asserted that it did not have sufficient nexus with any jurisdiction outside Montgomery to be subject to a tax collection obligation.

The ALD agreed with the Taxpayer but did so on the grounds of state law (not U.S. constitutional law). The ALD held that the Taxpayer was not subject to assessment because the regulations of the Alabama Department of Revenue (the "Department") as well as Alabama precedent insulated the Taxpayer from tax liability. *See* ALA. ADMIN. CODE r. 810-6-3-.51(2); *Yelverton's, Inc. v. Jefferson County, Alabama*, 742 So.2d 1216 (Ala. Civ. App. 1997). Quoting generously from its prior orders, the ALD provided a thorough analysis of the U.S. constitutional nexus requirements, ultimately finding that the Constitution afforded no protection to the Taxpayer.

The ALD first noted, consistent with existing Alabama decisional law, that in the *interstate context* the nexus analysis involved both the Due Process and the Commerce Clauses. However, in the *intrastate context*, only the Due Process Clause requirements had to be satisfied. Interstate commerce is generally not affected when sale transactions involve only one state. The ALD noted that the much more relaxed standard of the Due Process Clause does not require physical presence to establish nexus with a jurisdiction. *See Quill Corp. v. North Dakota*, 112 S. Ct. at 1911. Rather, if an out-of-jurisdiction taxpayer purposefully avails itself of the benefits of an economic market in the jurisdiction, it may be subject to the jurisdiction's *in personam* jurisdiction even if it has no physical presence there. *Quill*, 112 S. Ct. at 1910. Further, the Due Process Clause requirements are satisfied if a taxpayer has fair warning that its activities may subject it to the jurisdiction of a foreign sovereign. *Quill*, 112 S. Ct. at 1911. The Court noted that the repairmen all physically visited the local jurisdictions in which customer repairs were performed. However, the facts did not show the number of repairmen employed by the Taxpayer during the assessment period, nor the number and frequency of visits they made to the local jurisdictions. The ALD noted that the number and frequency of visits made by the repairmen to the local jurisdictions would be relevant in deciding whether the Taxpayer had sufficient activity in or contact with the local jurisdictions to constitute Due Process Clause nexus under *Quill v. North Dakota*.

The Court ultimately concluded that the more significant contacts required by the Department regulations and Alabama precedent required that the assessment be abated. Without evidence that the Taxpayer had a retail location outside Montgomery or that the repairmen solicited sales for the Taxpayer in the various local jurisdictions, the Department's assessment could not be upheld.

North Carolina – Due Process Clause Limitations on Penalty Imposition

On January 12, 2011, the Superior Court of Wake County, North Carolina, in *Delhaize America, Inc. v. Lay*, No. 06CVS08416, 2011 WL 1679628, at *16 (N.C. Super. Ct. Jan. 12, 2011), addressed (among other issues) the U.S. constitutional restraints imposed on penalty imposition. Delhaize America, Inc. (formerly Food Lion) ("Delhaize"), a North Carolina company, reorganized its operations in an effort to effect North Carolina tax savings. To achieve the savings, assets of Delhaize were transferred to related entities outside North Carolina and payments were made by Delhaize to its out-of-state affiliates for services and the use of certain intellectual property. The end result was less North Carolina state income tax.

On audit, the North Carolina Department of Revenue (the "Department") forced Delhaize and its affiliates to file a combined North Carolina return and imposed an *automatic* 25 percent penalty based on the assessed tax. Under North Carolina law in effect during the years at issue, separate company returns were required, and no guidelines informing taxpayers of when the Department would require a combined return were published. The court summarized the state of North Carolina law as follows:

> [T]axpayers, including this taxpayer [Delhaize], 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 . . . when due. Thus, after an audit, the taxpayer receives a substantial penalty for following the law.[1]

The issue was whether, under these circumstances, an automatic penalty comported with the protections of the federal Due Process Clause.

The court began its analysis by noting that penalties paid by taxpayers to the government are property interests protected by procedural due process. As a result, taxpayers must receive notice and an opportunity to be heard before the government may deprive them of their property. 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. Under these guidelines, the court concluded that the Due Process Clause prohibited imposition of the 25 percent penalty on Delhaize. The court reasoned as follows:

> 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 . . . , then ordinary taxpayers "exercising ordinary common sense" cannot sufficiently understand or predict when a penalty will be assessed. . . . Additionally, taxpayers cannot arrange their affairs to avoid punishment because no published criteria exists with which they can comply. . . . 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 . . . .[2]

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[1] *Delhaize Am., Inc. v. Lay*, No. 06CVS08416, 2011 WL 1679628, at *16 (N.C. Super. Ct. Jan. 12, 2011).

[2] *Id.* at 17.