

THE APPLICATION OF FEDERAL TAX LAW IN NORTH CAROLINA TAX CASES*

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[The taxing power], I contend, is manifestly a concurrent and coequal authority in the United States and in the individual States.

—Alexander Hamilton, *The Federalist*, No. 32.¹

In 2017, the Supreme Court of North Carolina rendered its decision in *Fidelity Bank v. North Carolina Department of Revenue*.² The issue presented in that case was whether the word “interest” as used in the North Carolina Revenue Act³ (the “Revenue Act”) should be construed in accordance with the meaning given the term in the Internal Revenue Code (the “Code”). The court held that absent a “clear and specific reference” in the Revenue Act to the Code’s definition of “interest,” that definition did not apply, and the term must be construed in accordance with its plain meaning.⁴

While the narrow issue in *Fidelity Bank* was the interpretation of a single word, the case shines a revealing light on a large and important question: to what extent do federal tax rules control the outcome of North Carolina tax controversies? That question is important because taxpayers and the North Carolina Department of Revenue (the “Department”) share an interest in knowing what law governs a given case. More broadly, the answer to this question has important consequences for the state’s ability to prevent the erosion of its “concurrent and coequal authority” over the taxing power within our federal system.

THE CONSTITUTIONAL BACKGROUND

The states’ taxing power is a core aspect of their sovereignty—one which the ratification of the Constitution left essentially unimpaired. Indeed, the Framers were eager to reassure the states on this issue.⁵ The Constitution

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1. THE FEDERALIST NO. 32, at 156 (Alexander Hamilton) (Cary & McClellan eds., 2001).

2. 370 N.C. 10, 803 S.E.2d 142 (2017)

3. North Carolina’s Revenue Act is contained in Chapter 105 of the North Carolina General Statutes. See N.C. GEN. STAT. § 105-1 to 105-570 (2017 & Supp. 2019).

4. *Fid. Bank*, 370 N.C. at 20, 803 S.E.2d at 150.

5. As Alexander Hamilton stated in *Federalist No. 32*:

[T]he individual states should possess an independent and uncontrollable authority to raise their own revenues for the support of their own wants . . . I affirm that (with the sole

does, of course, place some limits on state taxing power, such as the express prohibition on state import and export duties.⁶ Other limitations have been applied through the Privileges and Immunities Clause,⁷ the Supremacy Clause⁸ and the Fourteenth Amendment.⁹ However, the most important constitutional limitation on state taxing power is the Commerce Clause.¹⁰ In the mid-1960s, Congress entertained the idea of using the Commerce Clause to impose uniformity on state corporate income tax laws. The states vehemently opposed this effort as an affront to their sovereignty, and Congress stayed its hand when the states took voluntary steps toward uniformity on their own.¹¹ Since then, Congress has been hesitant to use the

exception of duties on imports or exports) they would retain that authority in the most absolute and unqualified sense; and that any attempt on the part of the national government to abridge them in the exercise of it would be a violent assumption of power unwarranted by any article or clause of the Constitution.

THE FEDERALIST NO. 32, *supra* note 1, at 154 (Alexander Hamilton). In a number of decisions beginning in the Marshall era, the Supreme Court entrenched the Hamiltonian view into constitutional law. *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 199 (1824) (“The power of taxation . . . is a power which, in its own nature, is capable of residing in, and being exercised by, different authorities at the same time. We are accustomed to seeing it placed for different purposes, in different hands . . . This does not interfere with the power of the States to tax for the support of their own governments; nor is the exercise of that power by the States an exercise of any portion of the power that is granted to the United States.”); *see also* *Union Pac. R.R. Co. v. Peniston*, 85 U.S. (18 Wall.) 5, 29 (1873) (“That the taxing power is one if its attributes of sovereignty; that it exists independently of the Constitution of the United States, and undervived from that instrument; and that it may be exercised to an unlimited extent on all property, trades, business and avocations existing or carried on within its territorial boundaries of the State, except so far as it has been surrendered to the federal government either expressly or by necessary implication, are propositions that have often been asserted by this Court. And in thus acknowledging the extent of the power to tax belonging to the states, we have declared that it is indispensable to their continued existence.”).

6. U.S. CONST. art. I, § 10, cl. 2.

7. U.S. CONST. art. IV, § 2, cl. 1; *see, e.g.*, *Toomer v. Witsell*, 334 U.S. 385, 403 (1948) (striking down a shrimp boat license fee that discriminated against nonresident boat owners).

8. U.S. CONST. art. VI, cl. 2; *see McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 436 (1819) (applying the Supremacy Clause to hold that Maryland could not tax notes issued by the Bank of the United States).

9. *See, e.g.*, *Allegheny Pittsburgh Coal Co. v. Cty. Comm’n*, 488 U.S. 336, 346 (1989) (invalidating under the Equal Protection Clause of the Fourteenth Amendment a property tax regime that taxed recently sold parcels at much higher valuations than other parcels). Just this year the Court invoked the Fourteenth Amendment’s Due Process Clause to invalidate North Carolina’s attempt to tax a foreign trust that had minimal connections to the state. *See N.C. Dep’t of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 139 S. Ct. 2213, 2228 (2019). The Court has also restricted the states’ ability to tax publications as an infringement of the First Amendment. *See Minneapolis Star & Tribune Co. v. Minn. Com’r of Revenue*, 460 U.S. 575, 593 (1983).

10. U.S. CONST. art. I, § 8, cl. 3.

11. *See* H.R. REP. NO. 89-952, pt. 6, at 1143 (1964) [hereinafter Willis Commission Report]. Known as the “Willis Commission Report,” this report recommended “the enactment [by Congress] of legislation providing a workable method of State income taxation of multistate business under uniform rules governing division of income, jurisdiction to tax, and the basic definition of taxable income.” *Id.* For the state response to the Willis Commission’s recommendations, *see, for example*, II RICHARD D. POMP, *STATE & LOCAL TAXATION* 10-04 to -05 (8th ed. 2015).

Commerce Clause to regulate state taxation, limiting itself to a small number of discrete prohibitions.¹²

The Supreme Court has been more active in policing the bounds of state taxing power through its dormant Commerce Clause jurisprudence, but it has not used that doctrine to promote a “normative state and local tax regime.”¹³ Indeed, the Court has recently loosened its Commerce Clause restrictions on state taxing power out of respect for state sovereignty.¹⁴ As a result, and subject always to the possibility that Congress may one day more fully exercise its positive Commerce Clause powers, state tax sovereignty remains constitutionally robust. To this extent, at least, the Hamiltonian doctrine of concurrent and coequal taxing authority is alive and well.

FORMAL LINKS BETWEEN THE STATE AND FEDERAL TAX SYSTEMS

Although state autonomy in tax matters may be constitutionally secure, North Carolina has voluntarily ceded some of that autonomy to the federal government.

The state’s Individual Income Tax¹⁵ and the Corporation Income Tax¹⁶ share a common tax base with their federal counterparts. The starting point for computing North Carolina income is federal adjusted gross income (for individuals) and federal taxable income (for corporations), both as determined under the Code.¹⁷ Adopting the federal tax base creates efficiencies for taxpayers and the Department. Taxpayers are able to compute their income for federal and state purposes under a single set of rules. The Department, by requiring taxpayers to report changes to their federal returns resulting from a federal audit,¹⁸ can rely on the Internal Revenue Service to police the common tax base.

12. See, e.g., Internet Tax Freedom Act, Pub. L. No. 105-277, div. C, tit. XI, 112 Stat. 2681-719 (1998) (amended 2007) (prohibiting state internet access taxes and discriminatory taxes on internet transactions); Interstate Income Act of 1959, Pub. L. No. 86-272, 73 Stat. 555 (prohibiting states from imposing income taxes on nonresident persons engaged in interstate commerce with minimal contacts to the taxing state).

13. William F. Fox & John A. Swain, *The Federal Role in State Taxation: A Normative Approach*, 60 NAT’L TAX J. 611, 619 (2007). For instance, while taxes on interstate actors must be fairly apportioned, the Court has tolerated a wide variety of apportionment systems. See, e.g., *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 280–81 (1978) (upholding single sales factor apportionment).

14. In last year’s decision in *South Dakota v. Wayfair*, 138 S. Ct. 2080 (2018), the Court described the judge-made rule that states could not impose sales tax collection obligations on remote sellers without an in-state physical presence as “an extraordinary imposition by the Judiciary on States’ authority to collect taxes and perform critical public functions.” *Id.* at 2086.

15. See N.C. GEN. STAT. §§ 105-153.1 to -159 (2017).

16. See *id.* §§ 105-130 to -130.25. Income taxes are also imposed on trusts and estates. See *id.* §§ 105-160 to -160.8.

17. *Id.* §§ 105-130.5, -153.4.

18. See *id.* §§ 105-130.20, -159.

In addition to tax base conformity, North Carolina tends to borrow specific rules and definitions from the Code.¹⁹ The Code thus serves as a sort of tax thesaurus for state legislative drafters. For instance, North Carolina has special rules governing related-party royalty payments, which rely on Code definitions and attribution rules to determine when two parties are related.²⁰ The Revenue Act also relies on more general aspects of the federal tax system. For instance, in computing state net income, corporations are required to employ tax accounting methods that “follow as nearly as practicable the federal practice.”²¹ Resorting to these federal rules can save time for legislative drafters and provide efficiencies to taxpayers familiar with the federal concepts.

These formal links between the federal and state income tax systems have not appreciably diminished North Carolina’s autonomy in tax matters. In addition to the income tax, North Carolina levies a variety of taxes that have no direct federal counterpart.²² These include the Franchise Tax,²³ the Insurance Company Gross Premiums Tax,²⁴ and various privilege and excise taxes.²⁵ In addition, the Sales and Use Tax,²⁶ which is the state’s second largest tax in terms of revenue contributed to the General Fund,²⁷ and the Property Tax,²⁸ which provides local governments with a major source of revenue, have no federal counterparts. These taxes are generally administered without reference to—and remain free from—the influence of federal tax law.

Even with respect to the income tax, state conformity to the federal tax base has its limits. The North Carolina Constitution prohibits delegation of the state’s taxing power.²⁹ The General Assembly thus is required annually to review amendments made to the Code and pick and choose those to which it

19. The Revenue Act includes over one hundred specific references to the Code. *See generally id.* § 105.

20. *See id.* § 105-130.7A (referencing Code §§ 318, 1563(b)).

21. *Id.* § 105-130.15(a).

22. *See generally id.* §§ 105-1 to -270.

23. *See id.* §§ 105.114 to -129.

24. *See id.* §§ 105-228.3 to -228.10.

25. These include the various privilege taxes levied under Article 2 of Subchapter I of the Revenue Act, the Tobacco Products Tax (Article 2A), the Alcoholic Beverage License and Excise Taxes (Article 2B), the Unauthorized Substance Taxes (Article 2D), the Highway Use Tax (Article 5A), the Scrap Tire Disposal Tax (Article 5C), the Dry Cleaning Solvent Tax (Article 5D), the Piped Natural Gas Tax (Article 5E), the Solid Waste Disposal Tax (Article 5G), the Severance Tax (Article 5I), and the Excise Tax on Conveyances (Article 8E).

26. *See* N.C. GEN. STAT. §§ 105-164.1 to -164.44M (2017).

27. *See* N.C. DEPT. OF REVENUE, STATISTICAL ABSTRACT OF NORTH CAROLINA TAXES 2018, at 11 (advance ed. 2018).

28. *See* N.C. GEN. STAT. §§ 105-271 to -395.1.

29. N.C. CONST. art. V, § 2(1) (“The power of taxation . . . shall never be surrendered, suspended, or contracted away.”)

wishes to conform.³⁰ The annual review is more than a pro forma exercise. The federal government's willingness to borrow allows it to tolerate more erosion of the tax base than the state can accept without raising rates. The General Assembly therefore regularly "decouples" from base-eroding measures such as the federal bonus depreciation and expensing regimes.³¹ North Carolina has also changed the starting point for computing individual state taxable income from federal taxable income to federal adjusted gross income, thus ensuring the state's control over the deductions and exemptions available to individual taxpayers.³²

THE INFORMAL INFLUENCE OF FEDERAL TAX LAW

The federal influence on North Carolina's tax law is not limited to the common tax base and other formal links between the two systems. Federal tax law also exerts an informal influence on state tax law. The Revenue Act and the Code inevitably use a common vocabulary to describe or classify tax-related concepts, such as "interest," "dividends," "partner," and "lease." In addition, the state and federal income tax regimes must be applied to common situations. For instance, under both state and federal systems it may be necessary to determine whether the form of or label given to a particular transaction by the taxpayer should be respected, whether a taxpayer is acting in his own capacity or as an agent or conduit of another, or whether a transaction or arrangement has economic substance.

Tax practitioners often tend to assume that, absent a specific statutory directive, commonly used terms should be given the same meaning and that the evaluation of a transaction or arrangement should yield similar results under both tax regimes. As a result, tax lawyers and administrators tend to apply federal tax concepts to state tax issues without much careful thought as to whether the concepts have any basis in state law.³³

This tendency simply reflects the fact that state income tax laws are drafted and administered against the background of the much more thoroughly developed federal income tax system, including its vast regulatory, sub-regulatory and judicial components. As one federal report noted as early as 1964, because of its high rates and significance for all taxpayers, "the Federal income tax has become such a universally experienced and highly

30. This is done by annually updating the definition of the term "Code" in section 105-228.90 of the Revenue Act.

31. See N.C. GEN. STAT. §§ 105-130.5B, -153.6.

32. The limitation of the federal deduction for state and local taxes enacted as part of the 2017 Tax Cuts and Jobs Act, while motivated by reasons unrelated to state tax sovereignty, also has served to disentangle the state and federal tax systems. See Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 111 Stat. 2054 (codified in scattered sections of 26 U.S.C.).

33. See generally Jeffrey C. Glickman & Clark R. Calhoun, *The "States" of the Federal Common Law Tax Doctrines*, 61 TAX L. 1181 (2008).

significant fact of business life that it has come to dominate the entire field of income taxation.”³⁴

The informal influence of the federal tax system on state tax law is more difficult to monitor or even observe than the formal influences. It therefore has the potential to sew confusion and even to erode state tax sovereignty to a degree that is not fully appreciated. *Fidelity Bank* illustrates how taxpayers can be led astray by assuming state adherence to federal tax concepts.

FIDELITY BANK

The issue in *Fidelity Bank* was whether the term “interest” as used in section 105-130.5(b)(1) of the Revenue Act should be interpreted to give the term the same breadth it has under the Code.³⁵ The taxpayer, a corporation, had purchased United States government bonds below their face value and held them until maturity. For federal purposes, the amount by which the face value of a debt instrument exceeds its purchase price is referred to as “market discount”³⁶ and, with limited exceptions, is treated as interest.³⁷

The North Carolina Corporation Income Tax is imposed on a corporation’s “State net income,” defined as the taxpayer’s “federal taxable income as determined under the Code” with certain adjustments.³⁸ One adjustment permits the subtraction of “interest” earned upon obligations of the United States.³⁹

The taxpayer argued that its market discount income was interest and that because the income was earned on U.S. government bonds, it could be subtracted in computing state net income. The taxpayer reasoned that because North Carolina uses federal taxable income “as determined under the Code” as the starting point for computing state net income, the General Assembly must have intended that the term “interest” as used in the Revenue Act be interpreted in accordance with the Code to include market discount income.

The Department made a strong argument that federal tax rules had no role in resolving the issue:

34. Willis Commission Report, *supra* note 11, at 255.

35. *Fid. Bank v. N.C. Dep’t of Revenue*, 370 N.C. 10, 11, 16, 803 S.E.2d 142, 143, 147 (2017).

36. See I.R.C. § 1278(a)(2) (2012). This provision was added to the Code by the Tax Reform Act of 1986. See Pub. L. No. 99-514, § 1803(a)(6), 100 Stat. 2085, 2793 (1986) (codified as amended at I.R.C. § 1278 (2012)). Before this amendment, any amount received by a bondholder at maturity attributable to market discount was treated as capital gain. See generally DAVID C. GARLOCK ET AL., FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS, ¶1101 (2019).

37. See 26 U.S.C.A. § 1276(a)(4) (Westlaw through Pub. L. 116-66).

38. See N.C. GEN. STAT. §§ 105-130.2(15), -130.5 (2017 & Supp. 2019); Act of August 1, 2019, ch. 187, § 1.(g) 2019-3 N.C. Adv. Legis. Serv. 198, 202 (LexisNexis) (to be codified at N.C. Gen. Stat. § 105-130.5(a)(30)).

39. See N.C. GEN. STAT. § 105-130.5(b)(1).

The North Carolina General Assembly has never adopted the Code wholesale The fundamental premise of Fidelity’s argument—that the North Carolina Revenue Act generally adopts the federal Code’s definitions—is incorrect. No provision of the Revenue Act incorporates the federal Code for all purposes. Instead, the Revenue Act selectively incorporates only certain provisions of the Code.⁴⁰

The Department argued that the taxpayer was grossly overreading the reference to “federal taxable income as determined under the Code.”⁴¹ That reference, the Department argued, cannot be read to incorporate federal tax principles for the purposes of interpreting the items to be subtracted from federal taxable income in computing state net income.⁴²

The Department also pointed to the many places in the Revenue Act where the legislature specifically adopted a Code definition. Under the principle of *expressio unius*, the General Assembly’s failure to expressly adopt the Code’s definition of “interest” must be viewed as intentional.⁴³

Finally, and most generally, the Department noted that “[t]he provision of the federal Code on which Fidelity relies, by its terms, does not extend to North Carolina law.”⁴⁴

Because the General Assembly had left the term “interest” undefined—by failing either to incorporate the federal definition or to supply a definition of its own, the Department argued that the case should be decided by applying the normal rules of statutory construction.⁴⁵ Undefined terms used in the Revenue Act “do not take on any specialized meaning they might have under the Code.”⁴⁶ Rather, they must be interpreted in accordance with their “ordinary meaning.”⁴⁷ The ordinary meaning of “interest,” according to the Department, is limited to “periodic payments” and does not include lump-sum amounts received at maturity.⁴⁸

The Supreme Court of North Carolina accepted the Department’s arguments in full. Applying general rules of statutory construction, the court found that the term “interest” is unambiguous and therefore must be given its plain meaning.⁴⁹ In determining that the plain meaning of the term was

40. See Brief for Respondent-Appellee at 18–19, *Fid. Bank*, 370 N.C. 10, 803 S.E.2d 142 (Nos. 392A16, 393PA16).

41. *Id.* at 18–25.

42. *Id.* at 21–22.

43. *Id.* at 22–24.

44. *Id.* at 24.

45. See *id.* at 29.

46. *Id.* at 21.

47. *Id.* at 23.

48. *Id.* at 16.

49. *Fid. Bank v. N.C. Dep’t of Revenue*, 370 N.C. 10, 18–19, 803 S.E.2d 142, 148–49 (2017).

“periodic payments received by the holder of a bond,”⁵⁰ the court ignored a large body of federal tax law and looked solely to state law precedents, specifically, a decision from 1874 involving a creditor’s action against a surety on a demand note providing for annual interest payments and a state statute providing for the monthly accrual of interest on delayed payments to contractors on public construction contracts.⁵¹

The court found no evidence of a legislative intent to incorporate federal tax concepts. Any decision to follow the federal definition “requires specific support in the relevant statutory language.”⁵² Specifically, “when the General Assembly intends to adopt provisions or definitions from other sources of law into a statute, it does so by ‘clear and specific reference.’”⁵³ The court found no such reference to the Code’s “interest” definition.⁵⁴

The court was untroubled by the fact that its holding created an inconsistency between the state and federal tax systems. “[T]he fact that Market Discount Income is treated as interest for purposes of determining federal taxable income does not . . . mean that Market Discount Income should be treated as ‘interest’ for all purposes under the North Carolina Revenue Act.”⁵⁵ There is also “nothing illogical,” the court reasoned, about treating the term differently for federal and state tax purposes.⁵⁶

Fidelity Bank is thus important both for establishing the principle that Code provisions are not incorporated into the Revenue Act absent a “clear and specific” statutory reference and for construing terms used in the Revenue Act by resorting to state law precedents without regard to the halo of federal tax lore that may surround them.

To a federal tax lawyer, limiting interest to “periodic payments” is a surprising result. For federal tax purposes, interest includes any amount

50. *Id.* at 20, 803 S.E.2d at 150. The court expressly adopted the Business Court’s conclusion that the “plain meaning” of “interest” is periodic payments received by the holder of a bond. *Id.* Neither the Business Court nor the Supreme Court of North Carolina cited a source for this definition.

51. *Id.* (citing *Knight v. Braswell*, 70 N.C. 709, 711–12 (1874)); see also N.C. GEN. STAT. § 143-134.1(a) (2017).

52. *Fid. Bank*, 370 N.C. at 21, 803 S.E.2d at 150.

53. *Id.* at 19, 803 S.E.2d at 149–50 (quoting *Lutz Indus. v. Dixie Home Stores*, 242 N.C. 332, 340, 88 S.E.2d 333, 339 (1955)).

54. The court’s holding was not entirely novel. In *In re North Carolina Inheritance Taxes*, the court observed in connection with the construction of the term “debts of the decedent” in North Carolina’s former inheritance tax law that “[w]hile the federal [estate tax] provisions provide some guidance, absent a clear indication of legislative intent to parallel federal law by use of identical language or otherwise, we cannot accept federal law as controlling.” 303 N.C. 102, 107, 277 S.E.2d 403, 408 (1981). *Fidelity Bank* represents a refinement of this approach by refusing to consider the Revenue Act’s use of the same term used in the Code as an indication of legislative intent to adopt the Code’s definition of the term.

55. *Fid. Bank*, 370 N.C. at 21, 803 S.E.2d at 150.

56. *Id.*

payable to a lender to compensate the lender for the use of its money, regardless of when paid.⁵⁷ To reach its conclusion in *Fidelity Bank*, the court had to ignore many years of federal income tax history.

In 1932, the United States Supreme Court issued a decision in *Old Colony Railroad Co. v. Commissioner*,⁵⁸ which is strikingly analogous to *Fidelity Bank*. The case concerned the federal income tax treatment of market premium rather than market discount.⁵⁹ The taxpayer issued bonds at a premium above their stated principal amount, reflecting an above-market nominal interest rate payable on the bonds.⁶⁰ The taxpayer argued that the “interest” it was entitled to deduct was the nominal interest paid on the bonds.⁶¹ The Commissioner of Internal Revenue argued that the premium should be amortized over the life of the bonds, effectively adjusting the nominal interest rate downward and reducing the taxpayer’s interest deductions.⁶²

The Court, in the same manner as the state supreme court in *Fidelity Bank*, applied normal rules of statutory construction and the “known and ordinary signification” of statutory terms.⁶³

In the ordinary affairs of life, no one stops for a refined analysis of the nature of a premium, or considers that the periodic payment universally called “interest” is in part something wholly distinct — that is, a return of borrowed capital. It has remained for the theory of accounting to point out this refinement. We cannot believe that Congress used the word having in mind any concept other than the usual, ordinary, and everyday meaning of the term, or that it was acquainted with the accountants’ phrase “effective rate” of interest, and intended that as the measure of the permitted deduction.⁶⁴

Any federal tax lawyer today would smile at such a quaint result. Indeed, the result was effectively reversed by regulations issued in 1957.⁶⁵ In 1965, the

57. See *Deputy v. Du Pont*, 308 U.S. 488, 498 (1940) (defining interest as “compensation for the use or forbearance of money”); see also GARLOCK ET AL., *supra* note 36, at ¶1101. As this treatise also points out, the federal rule treating all market discount as interest is also objectionable, since market discount may reflect a decline in the issuer’s creditworthiness rather than a change in interest rates. In such a case the discount may reflect the potential for collecting less than the full amount of principal at maturity. *Id.*

58. 284 U.S. 552 (1932).

59. *Id.* at 557.

60. *Id.* at 558.

61. *Id.* at 559.

62. *Id.* at 555.

63. *Id.* at 560.

64. *Id.* at 560–61.

65. See T.D. 6272, 1957-2 C.B. 18, reprinted in 22 Fed. Reg. 9418 (Nov. 26, 1957) (codified as Treas. Reg. § 1.61-12(c) (1957)). The current rules requiring issuers to amortize bond premium as an offset to their interest deductions are found in Treas. Reg. § 1.163-13 (1960).

Supreme Court recanted, recognizing that original issue discount on a zero coupon bond was interest rather than capital gain, and disavowing its primitive statements in *Old Colony* by noting that “[t]he concept of discount or premium as altering the effective rate of interest is not to be rejected as an ‘esoteric concept derived from subtle theoretic analysis.’”⁶⁶ These developments have been described as a “process under which specific federal tax law concepts have supplanted common law notions of what constitutes interest for tax purposes.”⁶⁷

That the Supreme Court of North Carolina in 2017 found itself in the same place the United States Supreme Court had occupied in 1932 and had since abandoned by 1965 illustrates the degree to which federal tax law has outpaced state tax law. More importantly, the Supreme Court of North Carolina’s willingness to ignore decades of federal tax development demonstrates the strength of its commitment to deciding state tax issues solely by reference to state law.

THE SCOPE OF *FIDELITY BANK*

The Code, of course, is not the only source of federal tax law. It is supplemented by a vast and ever-expanding library of tax regulations, revenue rulings, revenue procedures, technical advice memoranda and other administrative interpretations. If, under *Fidelity Bank*, the General Assembly cannot be assumed to have incorporated the Code *en bloc* into the Revenue Act, it should go without saying that none of this administrative matter has any direct force in North Carolina tax law absent a “clear and specific” statutory reference.

When states have wished to sanction reliance on federal administrative tax law, they have typically done so by specific enactments. For instance, a Colorado statute provides not only that any term used in the Colorado revenue law shall have the same meaning “as when used in a comparable manner in the internal revenue code” but also that:

[d]ue consideration shall be given in the interpretation of this article to applicable sections of the internal revenue code in effect from time to time and to federal rulings and regulations interpreting such sections if

66. *United States v. Midland-Ross Corp.*, 381 U.S. 54, 61 (1965) (quoting *Old Colony R.R. Co.*, 284 U.S. at 561). Congress began the process of requiring deferred payments to be treated as interest by enacting Code § 483 in 1964. *See* Revenue Act of 1964, Pub. L. No. 88-272, § 224(a), 78 Stat. 19, 77 (codified as amended at I.R.C. § 483 (2012)). Section 483 was supplemented by enactment of the original issue discount rules in 1969, which were significantly amended in 1982 and 1984. *See* Tax Reform Act of 1984, Pub. L. No. 98-369, §§ 41–44, 98 Stat. 494, 531–59 (codified as amended in scattered sections of 26 U.S.C.); Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 231(a), 98 Stat. 324, 496 (repealed 1984); Tax Reform Act of 1969, Pub. L. No. 91-172, § 413(a), 83 Stat. 487, 609 (repealed 1984).

67. *See* GARLOCK ET AL., *supra* note 36, ¶101.02[A].

such statute, rulings, and regulations do not conflict with the provisions of this article.⁶⁸

The wisdom of such a wholesale incorporation of federal administrative guidance, and even its legality under non-delegation principles, could be debated. But—suffice it to say—it has no counterpart in North Carolina law.⁶⁹

The decisions of the United States Tax Court and the tax decisions of the other federal courts are another important source of federal tax law. Federal judicial decisions in tax matters may, among other things, supply meaning to undefined terms,⁷⁰ reorder transactions,⁷¹ or ignore transactions as mere shams.⁷² Some states have authorized the application of federal judicial tax decisions to resolve state tax matters.⁷³ North Carolina has not.⁷⁴

If federal tax opinions are to be given effect in state tax matters, care must be taken to identify which decisions are to be followed. Oregon, for instance, has adopted rules for resolving conflicts between federal courts in determining which federal decisions are to be applied in state cases.⁷⁵ Giving effect to federal judicial decisions without specific rules of this sort necessarily would lead to confusion. North Carolina's lack of any rules for reconciling inconsistent federal opinions is evidence that the legislature does not intend them to have any application in state tax cases.

The lesson, then, of *Fidelity Bank* is that none of the Code, federal administrative tax law, nor federal judicial tax decisions have any direct

68. COLO. REV. STAT. ANN. § 39-22-103(11) (Westlaw through 2019 Reg. Sess.). Kentucky and Maryland also specifically incorporate federal administrative tax rulings. See KY. REV. STAT. ANN. § 141.050 (Westlaw through 2019 First Extraordinary Sess.); MD. CODE ANN., TAX-GEN. § 10-107 (Westlaw through 2019 Reg. Sess.).

69. North Carolina law does require the application of federal regulatory tax guidance in discrete cases. For example, the Secretary of Revenue is required to apply “the standards contained in the regulations adopted under section 482 of the Code” to determine whether transactions between affiliates are at arm’s length. N.C. GEN. STAT. § 105-130.5A(h) (2017).

70. See, e.g., *Higgins v. Comm’r*, 312 U.S. 212, 215 (1941) (interpreting “trade or business”).

71. The *locus classicus* is *Kimbell-Diamond Milling Co. v. Commissioner*, treating a stock purchase followed by a liquidation as an asset purchase. 187 F.2d 718 (5th Cir. 1951). This case has been superseded by the enactment of Code section 338. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 224, 96 Stat. 324, 485 (codified as amended at I.R.C. § 338 (2012)).

72. See, e.g., *Comm’r v. Culbertson*, 337 U.S. 733 (1949).

73. Kentucky authorizes the use of “judicial interpretations of the federal income tax law,” KY. REV. STAT. ANN. § 141.050, and Maryland provides that “[t]o the extent practicable, the Comptroller shall apply . . . judicial interpretations of the federal income tax law to the administration of the income tax laws of this State,” MD. CODE ANN., TAX-GEN. § 10-107.

74. Rather than authorizing application of federal judicial tax doctrines, some states have enacted their own broad anti-abuse doctrines into law. See, e.g., MASS. GEN. LAWS ANN. ch. 62C, § 3A (Westlaw through 2019 legislation). North Carolina has enacted its own economic substance doctrine for the limited purpose of determining whether corporations may be required to file a combined return. See N.C. GEN. STAT. § 105-130.5A(g).

75. See OR. REV. STAT. ANN. § 314.011(3) (Westlaw through 2018 Special Sess. of the 79th Legis. Assemb.).

application to the resolution of state tax issues.⁷⁶ Any one or more of these authorities, of course, may be incorporated into North Carolina law by a “clear and specific” statutory reference; the reasoning behind them may certainly be noticed by state courts deciding state cases; and the Department may adopt similar guidance through rulemaking—all without giving the federal authorities direct application. To apply federal authorities directly to state tax matters would avoid the difficulty, but also the legitimacy, of actual lawmaking.⁷⁷

AN UNLEARNED LESSON

An “*Important Notice*” issued by the Department in September 2018 shows that the lesson of *Fidelity Bank* has not yet been fully absorbed.⁷⁸

76. An exception could be justified with respect to the common tax base. The phrase “as determined under the Code” can plausibly be read to require the application of federal administrative and judicial interpretations of the Code provisions that govern the calculation of federal taxable income (for corporations) or federal adjusted gross income (for individuals). Application of a separate set of state-specific interpretive rules would defeat the purpose of the common tax base and would therefore arguably be contrary to legislative intent. The Department generally relies on the Internal Revenue Service audit process to police the common tax base. However, the Revenue Act does not preclude the Department from making an assessment, or the taxpayer from seeking a refund, in the absence of a federal determination. In these cases, the Department must apply federal Treasury Regulations and other federal guidance on its own. *See, e.g., In re Proposed Assessment of Corp. Income Taxes for Tax Years Ended Dec. 31, 1989 and 1990 by the Sec’y of Revenue of N.C.*, 1997 N.C. Tax Lexis 48, No. 95-144 (N.C. Dep’t of Revenue Aug. 26, 1997) (claiming the ability to apply federal judicial tax doctrines to independently redetermine a taxpayer’s federal taxable income). This circumstance presents a separate issue. The Department’s interpretations of the “laws administered by the Secretary [of Revenue]” are *prima facie* correct. N.C. GEN. STAT. § 105-264(a) (2017). But it must be doubted whether the state’s adoption of the federal tax base makes the Secretary’s interpretations of Code provisions *prima facie* correct. Taxpayers challenging an assessment or a refund denial based on the Department’s independent interpretation of the Code should not be required to overcome a presumption of correctness. *See Martin v. N.C. Dep’t of Health & Human Servs.*, 194 N.C. App. 716, 720, 670 S.E.2d 629, 632 (2009) (“A state agency’s interpretation of federal statutes” will not be given “the deference afforded a federal agency’s interpretation of its own statutes.” (quoting *GTE South, Inc. v. Morrison*, 199 F.3d 733, 745 (4th Cir. 1999))).

77. Under the North Carolina Constitution, “[o]nly the General Assembly shall have the power to classify property for taxation.” N.C. CONST. art. V, § 2(2). This provision has been interpreted to mean that the state’s taxing power must be exercised by the legislature. *See, e.g., Hajoca Corp. v. Clayton*, 277 N.C. 560, 568, 178 S.E.2d 481, 486 (1971); *De Loatch v. Beamon*, 252 N.C. 754, 757, 114 S.E.2d 711, 713 (1960); *Henderson Cty. v. Smyth*, 216 N.C. 421, 5 S.E.2d 136, 137–38 (1939); *Person v. Bd. of State Tax Comm’rs*, 184 N.C. 499, 502, 115 S.E. 336, 339 (1922). It could be argued that an attempt by the Department, even through formal rulemaking, to incorporate federal judicial decisions or administrative guidance would exceed its mandate to interpret state law and unconstitutionally intrude into the legislative sphere.

78. N.C. DEP’T OF REVENUE, IMPORTANT NOTICE: TAX CREDITS INVOLVING PARTNERSHIPS (2018), https://files.nc.gov/ncdor/documents/files/tax_credits_important_notice_1.pdf [https://perma.cc/27J7-WSKJ]. An “Important Notice” is a “nonbinding interpretive statement within the delegated authority of an agency that merely define[s], interpret[s], or explain[s] the meaning of a statute or rule.” N.C. GEN. STAT. § 150B-2(8a)c.

The notice concerns partnerships engaging in activities giving rise to North Carolina tax credits and passing those credits through to their partners through partnership allocations. The notice discusses two situations in which, according to the Department, an investor in such a partnership would not be entitled to claim his allocable share of the credit generated by the partnership.⁷⁹ The first is where the investor is not in fact a “bona fide partner” in the partnership.⁸⁰ The second is where the investor, though a bona fide partner, purchases the credit from the partnership through a “disguised sale” rather than receiving it through a partnership allocation.⁸¹

The Revenue Act does not include any rules under which a partner’s status may be ignored as not being “bona fide” or treating purported partnership allocations as “disguised sales.” Moreover, the North Carolina courts have not developed a body of tax law on these issues, and the Department has not addressed them through rulemaking.

There is, however, federal income tax law on both issues. The federal courts have issued a number of decisions addressing an investor’s “bona fide” partner status,⁸² and Code § 707 and the Treasury Regulations issued thereunder contain elaborate rules for treating certain transactions between partners and partnerships as disguised sales.⁸³ The Revenue Act, however, does not include any “clear and specific reference” either to Code § 707 or the federal bona fide partner doctrine. Until North Carolina develops its own law on these matters, by legislation, administrative rulemaking, litigation, or enacting a clear and specific reference to the federal law, these concepts are simply not a part of North Carolina law.

The *Important Notice* nevertheless attempts to incorporate these federal rules into North Carolina law by turning *Fidelity Bank* on its head. The clear doctrine of *Fidelity Bank* (and the argument the Department forcefully advocated in that case) is that federal conformity is the exception and state independence in tax matters is the rule. The *Important Notice* states the opposite: “North Carolina generally follows the Code, subject to statutory exceptions and definitional differences.” In other words, state adherence to the Code is the rule absent a statutory exception. Based on this extraordinary misreading of *Fidelity Bank*, the notice states that “section 707 of the Code and the regulations thereunder” apply directly to determine whether a partner can

79. *Id.* at 1–2.

80. *Id.*

81. *Id.*

82. See *Historic Boardwalk Hall, LLC v. Comm’r*, 694 F.3d 425, 445 (3d Cir. 2012).

83. See generally I.R.C. § 707 (2012) (discussing transactions between a partner and the partnership); Treas. Reg. § 1.707-3 (1992) (defining when transfer of property by a partner to a partnership will be treated as a sale of property for tax purposes).

claim a partnership-generated North Carolina tax credit.⁸⁴ The notice also refers to *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*,⁸⁵ a federal judicial decision that applied Code § 707, and states that because it “is a Fourth Circuit Court of Appeals decision, the case is controlling for North Carolina.”⁸⁶ Of course, Fourth Circuit decisions are controlling for the resolution of federal tax issues for North Carolina residents, but there is no authority for referring to such decisions as controlling for state tax purposes.⁸⁷

The notice goes on to refer to a federal income tax decision from the Third Circuit⁸⁸ addressing the bona fide partner issue and advises taxpayers that this decision is “relevant” in determining whether a partnership investor may validly claim a North Carolina tax credit passed through from the partnership.⁸⁹ The notice does not explain why the decision is “relevant” other than as an interesting data point, or why it is any more “relevant” for North Carolina tax law than the Tax Court decision it reversed, which for federal purposes controls outside the Third Circuit.⁹⁰

That the Department issued this notice after successfully advocating the contrary position in *Fidelity Bank* just one year before illustrates how easily state tax administrators can lose sight of the independence of the law they administer in the face of a federal system that “dominates the field.”

CONCLUSION

The Department’s 2018 *Important Notice* highlights the confusion that continues to cloud the issue of when federal tax authorities may be applied to resolve North Carolina tax cases. The complete resolution of the issue likely will require additional judicial development or legislative action. While *Fidelity Bank* therefore might not be the last word, it should awaken North

84. Before its repeal by the Tax Cuts and Jobs Act, § 708(b)(1)(B) of the Code provided for the technical termination of a partnership if more than half of the partnership interests were sold or exchanged in a twelve-month period. See Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13504(a), 111 Stat. 2054, 2142 (striking portions of I.R.C. § 708(b)). The *Important Notice* also states that § 708(b)(1)(B), before its repeal, was “also applicable” for North Carolina tax purposes, and that a partnership suffering a technical termination for federal purposes “would lose its allocable [state] tax credits.” N.C. DEP’T OF REVENUE, *supra* note 78, at 2.

85. 639 F.3d 129 (4th Cir. 2011).

86. N.C. DEP’T OF REVENUE, *supra* note 78, at 2.

87. See *supra* at note 67 and accompanying text (noting a possible exception where the case is relevant to the determination of the common tax base). It is also important to note that Fourth Circuit precedent is not necessarily applicable to North Carolina taxpayers investing in a partnership that has its principal place of business in another circuit, a subtlety that highlights the danger of the direct application of federal precedent to state tax cases without clear ordering rules. See I.R.C. § 7482(b)(1)(E) (Supp. III 2015); *Peat Oil & Gas Assocs. v. Comm’r*, 65 T.C.M. (CCH) 2259 (1993), *aff’d sub nom.* *Ferguson v. Comm’r*, 29 F.3d 98 (2d Cir. 1994).

88. *Historic Boardwalk Hall, LLC v. Comm’r*, 694 F.3d 425 (3d Cir. 2012).

89. N.C. DEP’T OF REVENUE, *supra* note 78, at 2.

90. See *Golsen v. Comm’r*, 54 T.C. 742 (1970), *aff’d* 445 F.2d 985 (10th Cir. 1971).

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Carolina tax lawyers from their dogmatic slumbers. As Justice Holmes said of the common law, the federal tax law is not a “brooding omnipresence in the sky, but the articulate voice of some sovereign or *quasi*-sovereign that can be identified.”⁹¹ No matter how articulately or how loudly the federal tax law speaks, in state tax matters it may persuade, but it does not command.

91. *C.f.* *S. Pac. Co. v. Jensen*, 244 U.S. 205, 222 (1917) (Holmes, J., dissenting).