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1999 STATE AND LOCAL TAX IMPORTANT DEVELOPMENTS



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NOTE
IT HAS BECOME CUMBERSOME - NORTH CAROLINA'S UNEVEN
APPLICATION OF INTANGIBLES TAX ON STOCK HELD
UNCONSTITUTIONAL:
SMITH V. STATE

In *Smith v. State*,¹ the Supreme Court of North Carolina struck down a state provision that allowed only those taxpayers who had filed protests within a certain time limit to recover their payment of an unconstitutional tax. The court held that the law was contrary to both U.S. Supreme Court precedent and the North Carolina Constitution. The court rejected the state's argument that the notification statute, which had divided the taxpayers, was valid and necessary, and recertified those plaintiffs who had not filed protests to the unconstitutional intangibles tax within the statutory notification period.

Part I of this Note covers the factual and legal backgrounds of *Smith*. Part II deals with the *Smith* ruling itself, and Justice Frye's concurrence, which picks up where the court left off. Part III is an analysis of the holding. It shows that the court's reasoning and reading of precedent was correct; the only flaw of any significance was not adopting the reasoning of the concurrence. Part IV concludes that despite the hardships associated with "forgiving" the intangibles tax, it appears that North Carolina will indeed be able to pay for the "forgiveness" it needs to come into compliance with the *Fulton* and *Smith* decisions.

I. BACKGROUND

In order to fully understand the issues in *Smith v. State*, it is first necessary to consider its legal grandparent, *Fulton v. Faulkner*, and that case's legal aftermath. Part A will examine the legal background of *Smith*, including *Fulton* and the North Carolina General Assembly's reaction. Part B will examine the factual background of *Smith*.

A. Legal Background (*Fulton v. Faulkner and Its Aftermath*)

For several years, North Carolina levied an intangibles tax on stock held by its residents, pursuant to North Carolina General Statutes section 105-203(1).² The law taxed stock at the rate of one quarter of one percent.³ However, the tax was at a rate inversely proportional to the amount of business the corporation did in North Carolina; hence, a corporation doing ten percent of its business in the state was taxed on ninety percent of the stock, and a corporation doing ninety percent of its business in North Carolina was taxed on ten percent of the stock.⁴ In effect, the stock of an entirely in-state corporation was completely tax-exempt,

¹507 S.E.2d 28 (N.C. 1998).

²N.C. GEN. STAT. § 105-203(1) (1992) (repealed 1995).

³See *id.*

⁴See *Fulton Corp. v. Justus*, 430 S.E.2d 494, 496 (N.C. Ct. App. 1993).

while the stock of an entirely out-of-state corporation was taxed at one hundred percent of its value.⁵

In 1991, Fulton Corporation brought suit in North Carolina arguing that the tax as applied violated the Commerce Clause of the U.S. Constitution.⁶ The trial court disagreed and entered summary judgment for the state.⁷ Fulton appealed to the North Carolina Court of Appeals, which promptly reversed.⁸ The Court of Appeals held that the taxable percentage deduction violated the Commerce Clause.⁹ However, that court awarded no relief and remanded the case to the trial court, ordering that the offending portion of the statute be declared unconstitutional.¹⁰ On appeal, the Supreme Court of North Carolina reversed.¹¹ The court held that, in light of the U.S. Supreme Court's murky precedent on the matter, the tax was within the state's right to enact a compensatory tax scheme on interstate commerce.¹² The court rested its opinion on *Darnell v. Indiana*,¹³ and on the Supreme Court's description of the state of compensatory tax law as a "quagmire."¹⁴

The United States Supreme Court granted certiorari¹⁵ and reversed.¹⁶ In an opinion by Justice Souter, the Court unanimously held that the intangibles tax as applied violated the Commerce Clause.¹⁷ The Court noted that the first step in determining if a tax violates the Commerce Clause "is to determine whether it regulates evenhandedly with only incidental effects on interstate commerce, or discriminates against interstate commerce."¹⁸ The Court then looked to whether the law at issue taxed more heavily business that crossed state lines than in-state business.¹⁹ A facially discriminatory tax might be acceptable as compensatory if it merely applies the same burden to interstate commerce that intrastate commerce already bears.²⁰

⁵See *id.* at 496.

⁶See *id.* at 494.

⁷See *id.* at 494.

⁸See *id.* at 495.

⁹See *id.* at 495.

¹⁰See *id.* at 504-505.

¹¹See *Fulton Corp. v. Justus*, 450 S.E.2d 728, 735 (N.C. 1994).

¹²See *id.* at 735.

¹³See 226 U.S. 390 (1912). The court determined that *Darnell*, which deemed constitutional a tax on the stock of foreign corporations to compensate for the property taxes paid by in-state corporations, was both good law, and the model for the intangibles tax considered here. See *id.* at 732-34.

¹⁴See *Fulton*, 450 S.E.2d at 731 (quoting *American Trucking Ass'n v. Scheiner*, 483 U.S. 266, 280 (1987)).

¹⁵See *Fulton Corp. v. Faulkner*, 514 U.S. 1062 (1995). In 1993, Janice Faulkner replaced Betsy Justus as Secretary of Revenue and as the named defendant in the case. "When a person is a party to an appeal in an official or representative capacity and during its pendency dies, resigns, or otherwise ceases to hold office, the action does not abate and [her] successor is automatically substituted as a party." N.C. R. App. P. 38(c).

¹⁶See *Fulton Corp. v. Faulkner*, 516 U.S. 325, 347 (1996).

¹⁷See *id.* at 344.

¹⁸See *id.* at 331 (internal quotations omitted).

¹⁹See *id.*

²⁰See *id.*

The Court then noted:

Our cases have distilled three conditions necessary for a valid compensatory tax. First, a state must, as a threshold matter, identify . . . the [interstate tax] burden for which the state is attempting to compensate . . . second, the tax on interstate commerce must be shown roughly to approximate – but not exceed – the amount of the tax on intrastate commerce . . . finally, the events on which the interstate and intrastate taxes are imposed must be substantially equivalent; that is, they must be sufficiently similar in substance to serve as mutually exclusive ‘proxies’ for each other.²¹

The Court rejected North Carolina’s position that the tax was a compensatory one, designed to pay for access to North Carolina’s capital markets.²² The Court also judged inaccurate the notions that the tax was no greater on out-of-state corporations, and that the tax fell on substantially similar events.²³ The Court distinguished *Darnell* by pointing out that *Darnell* dealt with Equal Protection, rather than Commerce Clause, issues, and was therefore not on point.²⁴ The Court concluded by remanding the case to the Supreme Court of North Carolina, with the notation that it is within the State’s discretion to correct the Commerce Clause disparity, by either refunding those adversely affected, or by taxing the former beneficiaries.²⁵

On remand, the North Carolina Supreme Court held that the tax itself was not unconstitutional;²⁶ however, the application of the tax, which benefited holders of in-state corporation stock and *de facto* penalized out-of-state corporation stockholders, was unconstitutional.²⁷ The state asked that the court sever the unconstitutional deduction;²⁸ because “a State found to have imposed an impermissibly discriminatory tax retains flexibility in responding to this determination,”²⁹ the court invalidated that portion of the statute.³⁰ This left the tax, on the whole, valid and enforceable.³¹ The court left to the General Assembly the decision mandated by the United States Supreme Court: either to tax the former beneficiaries of the tax, or to forgive the portion of the tax that penalized out-of-state stock.³²

To a limited extent, the North Carolina General Assembly followed the court’s directions. As the court suggested, the Assembly passed Chapter 17 of the 1997 Session Laws, exempting the prior beneficiaries of the tax from back payment of

²¹See *id.* at 332-33 (internal quotations and citations omitted).

²²See *id.* at 336.

²³See *id.* at 338-44.

²⁴See *id.* at 345. The Court also noted that the tax had been repealed while the suit was pending; however, that repeal was not retroactive. 516 U.S. at 325, n.1.

²⁵See *id.* at 346-47.

²⁶See *Fulton Corp. v. Faulkner*, 481 S.E.2d 8, 9 (1997), hereafter *Fulton (on remand)*.

²⁷See *id.* at 10.

²⁸See *id.*

²⁹*McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18, 39-40 (1990).

³⁰See *Fulton (on remand)*, 481 S.E.2d at 10.

³¹See *id.* at 9.

³²See *id.* at 11.

the tax.³³ However, the Assembly also passed Chapter 318 of the 1997 Session Laws, which effectively allowed only those taxpayers who had filed within the thirty day statutory period to recover the tax; those taxpayers who had not, were precluded by statute from civil action.³⁴

B. *Factual Background* (Smith v. State)

A second group of taxpayers brought a class-action suit for a refund of the intangibles tax. The trial court stayed the action until the resolution of *Fulton*.³⁵ When *Fulton* (*on remand*) was decided, the trial court determined that there were two possible classes of plaintiffs in suits stemming from the intangibles tax, Classes A and B.³⁶ Class A plaintiffs were those who had paid the intangibles tax for the applicable years, then filed for refunds under North Carolina General Statute section 105-267; Class B plaintiffs had also paid the tax, but had not filed within the thirty-day period mandated by section 105-267. The trial court ordered the suit to commence for both classes.³⁷ However, after the North Carolina Supreme Court issued *Fulton* (*on remand*), the General Assembly passed Chapters 17 and 318. After the passage of Chapter 17, but before the passage of Chapter 318, the trial court entered judgment for the Class A plaintiffs and decertified the Class B plaintiffs.³⁸

Donald Smith and the other plaintiffs were Class B plaintiffs – those who had paid the tax later modified under *Fulton*, but who did not file for a refund within the statutory period defined under section 105-267. These taxpayers appealed to the North Carolina Court of Appeals, which denied their request for recertification.³⁹ The Court of Appeals also turned down the taxpayers request for an *en banc* hearing.⁴⁰ The taxpayers appealed to the Supreme Court of North Carolina.

II. *SMITH v. STATE*

The Supreme Court of North Carolina reversed the trial court and reinstated the Class B plaintiffs.⁴¹ The court's decision in *Smith v. State* closely followed its holding in *Fulton v. Faulkner* (*on remand*), which in turn closely followed the U.S. Supreme Court's reasoning in *Fulton*. The court first reviewed the background of *Fulton*, to establish that, contrary to the parties' positions, the intangibles tax is, on its face, constitutional.⁴² However, the court also noted that the tax would only be constitutional if it was applied evenly to all stocks.⁴³ The

³³Act of Apr. 10, 1997, Ch. 17, § 1, 1997 N.C. SESS. LAWS 51.

³⁴Ch. 318, § 1, 1997 N.C. SESS. LAWS 51.

³⁵See *Smith v. State*, 507 S.E.2d at 28.

³⁶See *id.* at 30.

³⁷See *id.*

³⁸See *id.* at 32.

³⁹See *Smith v. State*, 500 S.E.2d 82 (N.C. Ct. App. 1998).

⁴⁰See *Smith v. State*, 500 S.E.2d 82, *motion for reh'g en banc denied*, 506 S.E.2d 254 (N.C. Ct. App. 1998).

⁴¹See *Smith v. State*, 507 S.E.2d at 32.

⁴²See *id.* at 32.

⁴³See *id.* at 32-3.

court reviewed the notification statute and the "forgiveness statute,"⁴⁴ and noted that the state was required, upon forgiving the former beneficiaries of liability under the intangibles tax, "to address the taxpayers who had paid the full intangibles tax."⁴⁵ It noted that the Assembly's response had been to order a reimbursement for some, but not all of the taxpayers.⁴⁶

North Carolina argued that the notification statute served the vital purpose of preparing the legislature for the existence of a possible adverse judgment.⁴⁷ The taxpayers countered that the state was required to forgive the tax because of *Fulton (on remand)*. Both parties treated the tax as unconstitutional.⁴⁸

The court's actual holding was brief and to the point. The court held that the trial court had erred in dismissing the Class B plaintiffs' claims.⁴⁹ The court first reiterated that the intangibles tax, correctly applied, was constitutional.⁵⁰ Nevertheless, it determined that the General Assembly's decision to tax, in effect, only those taxpayers who had not protested the tax within the statutory period was out of line with both *Fulton (on remand)* and 130 years of North Carolina's constitutional history.⁵¹ The court disagreed with the state, and ordered that Class B taxpayers be eligible for "forgiveness."⁵² The court cited both its holding in *Fulton* and the North Carolina Constitution, stating that the litigation scheme as ordered by the Assembly "violate[d] the uniformity provision of the North Carolina Constitution and therefore must fail."⁵³ Such a result, the court held, both discriminated against interstate commerce and violated those parts of the North Carolina Constitution that mandated uniform taxation.⁵⁴ The court reversed and remanded the case for a judgment consistent with its ruling in *Fulton (on remand)*.⁵⁵

In a separate concurring opinion, Justice Frye agreed with the court but added that the issue also should have been decided on prior precedent, which stated that the filing of lawsuits provided ample notification of an impending judgment.⁵⁶ In his opinion, the *Fulton* decision alone should have alerted the Assembly to the need to budget for a possible adverse judgment.⁵⁷

⁴⁴See *id.* at 31-2.

⁴⁵*Id.* at 31-2.

⁴⁶See *id.* at 32.

⁴⁷See *Smith v. State*, 507 S.E.2d at 33.

⁴⁸See *id.* at 32.

⁴⁹See *id.* at 33.

⁵⁰See *id.* at 32-3.

⁵¹See *id.* at 33.

⁵²See *id.*

⁵³See *Smith v. State*, 507 S.E.2d at 33.

⁵⁴See *id.* at 33.

⁵⁵See *id.*

⁵⁶See *Smith v. State*, 507 S.E.2d at 33 (Frye, J., concurring) (quoting *Bailey v. State*, 500 S.E.2d 54 (1998)).

⁵⁷See *id.* at 34 (Frye, J., concurring).

III. ANALYSIS

States and, by extension, their legislative bodies, are rational actors. Like all governments, they desire revenue in order to perform functions and services. Perhaps the only thing any government likes less than not collecting revenue is giving back what they have already collected. With this in mind, it is easy to understand the Assembly's actions in the aftermath of *Fulton*. The General Assembly made a rational choice: it decided to levy a tax that any staff attorney could have labeled potentially unconstitutional, and to fund state operations for a period of several years with those funds.⁵⁸ The Assembly gambled that, in one manner or another, it would not be required to pay back that revenue.⁵⁹ Although some commentators have questioned the court's reasoning in *Smith* and its grandparent,⁶⁰ especially with respect to state sovereignty,⁶¹ those concerns are largely beside the point. The real issue is that the Supreme Court of North Carolina effectively removed the incentive to cheat from the General Assembly, by eliminating the revenue gained from passing and maintaining an unconstitutional tax. In reaching this result, the court adhered to long-settled principles of the federal Commerce Clause and the North Carolina Constitution.

The court's reasoning in *Smith* was correct, both in its reading of the Supreme Court's holding in *Fulton*, and in its interpretation of the North Carolina Constitution. The trial court's determination that Class B plaintiffs were, by statute, ineligible for relief was a correct reading of the Assembly's wishes. The fault

⁵⁸Game theory is perhaps the best way to explain this choice. When North Carolina levied the tax, the taxpayers had two choices (excluding the choice not to pay and instead to face criminal charges or flee to a nation without extradition ties to the U.S.): to protest in court or simply to pay and go on with their lives. In response, a court could either invalidate the tax or leave the tax alone. Applying a simple Cournot-Nash-Punnet square produces four possible results: protest-invalidated, protest-leave alone, no-protest-invalidated, no-protest-leave alone. (For the sake of simplicity, I am not weighing in other factors, such as perceived likelihood of Supreme Court intervention, open revolution, etc. While this makes the scenario more simplistic, it does make the basic point). In other words, in only one of three possible scenarios would the Assembly be required to return its revenue from the intangibles tax (no protest-invalidated is essentially a null set, because the Case or Controversy requirement (and its state analogue) keeps courts from *sua sponte* invalidating laws). The Assembly was therefore running with roughly a sixty-seven percent chance of success, a highly rational gamble to make. Indeed, in the early stages of *Fulton*, it looked as if the intangibles "gamble" had been a sure thing.

⁵⁹Along the same lines as the game theory above, the Assembly again became involved in a game when it chose to create two classes of disadvantaged taxpayers: Essentially, the Cournot-Nash-Punnet square above can be used again here — this time, though, the likelihood of the protest-invalidated (refund) result might have been even lower, because some of the disadvantaged taxpayers would be "forgiven," and because the stated purpose of the notification statute was to serve the legitimate interest of helping the Assembly budget for potentially large adverse judgments.

⁶⁰See, e.g., Dana Edward Simpson, Note, *Choosing Fairness over Fundamentals: How Bailey v. North Carolina Undermines the Constitutional Prohibition Against the State Contracting Away Its Power of Taxation*, 77 N.C. L. REV. 2217, 2225, n.65 (1999); but see, e.g., Michael Haag and Michael Boekhaus, *The Final Nail in the Compensatory Tax Coffin? The Impact of the Supreme Court's Decision in Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), *On the Doctrine of Compensatory Taxes*, 21 HAMLINE L. REV. 451 (1998).

⁶¹See, e.g., Richard H. Seamon, *The Sovereign Immunity of States in Their Own Courts*, 37 BRANDEIS L.J. 319 (1998).

lay with the General Assembly. In fact, there seems to be little at issue (if such a beginning is not in itself ironic, given the millions of dollars at stake), save the threat of North Carolina being forced to return that which it unconstitutionally gained. If the court failed in any appreciable way, it was in not adopting Justice Frye's reasoning. Indeed, to endorse North Carolina's reasoning would involve some tortured leaps in logic, out of step with decades of Supreme Court Commerce Clause precedent and the current state of Commerce Clause jurisprudence.

While it is understandable that the General Assembly would balk at returning revenue it had already spent, North Carolina's proposal, drawn to its logical conclusion, ultimately forces a mixed retroactive-prospective second-guessing by taxpayers as to whether or not a tax will be ruled unconstitutional. Such a result is at odds with Commerce Clause doctrine.

It is a hackneyed, but no less accurate, truism that the Commerce Clause is the shield against economic Balkanization.⁶² While it is true that "a State found to have imposed an impermissibly discriminatory tax retains flexibility in responding to this determination,"⁶³ to allow states to duck the issue as the trial court did, would be little different from allowing the states to tax and control interstate commerce at will – the very Balkanization against which the Commerce Clause shields the nation. As the Supreme Court has sonorously intoned, albeit on another issue, "liberty finds no refuge in a jurisprudence of doubt."⁶⁴ The General Assembly's elimination of a whole sub-class of plaintiffs is, in theory, no different than taxing the whole class. To allow the former is to intimate the acceptability of the latter – provided that the state can produce the right notification statute and justification.

This reasoning in turn would essentially eviscerate *Fulton* and a long tradition of Supreme Court dormant Commerce Clause precedent. *Fulton* states that the intangibles tax levied during the first part of this decade was, as applied, unconstitutional. The Assembly was given the choice to either offer complete forgiveness of the tax – to remove the tax burden from the disadvantaged taxpayers – or to tax the former beneficiaries, the in-state stock holders. The Assembly chose to remove the burden from *some* of the disadvantaged. This is not unlike obeying the desegregation order in *Brown v. Board of Education* – but only in half of the schools of Topeka.⁶⁵

Moreover, the recent history of the dormant Commerce Clause lies against any decision to unduly burden interstate commerce. For example, in *Oregon*

⁶²See, e.g., *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 180 (1995) (stating that the Commerce Clause reflects the Framers' concern about "the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation") (internal quotations and citations omitted).

⁶³*McKesson*, 496 U.S. at 39-40.

⁶⁴*Planned Parenthood of Southeastern Pennsylvania v. Casey*, 505 U.S. 833, 843 (1992).

⁶⁵See *Brown v. Topeka Board of Education*, 347 U.S. 483 (1954).

Waste Systems v. Dep't of Environmental Quality,⁶⁶ the Supreme Court held that a surcharge on out-of-state waste, despite the obvious basis for trying to prevent out-of-state garbage from entering a state, was unconstitutional.⁶⁷

As with its Commerce Clause holding, the court's interpretation of the North Carolina Constitution was accurate. As the court noted, over one hundred and twenty years of state constitutional and common law history should have clarified the rule of uniform taxation. The plain meaning of Article V, section 2(2) of the North Carolina Constitution is straightforward: "No class of property shall be taxed except by uniform rule." Further, as the North Carolina Supreme Court has noted on more than one occasion, "the [North Carolina] Constitution does not permit a state to levy a tax which discriminates in favor of or against taxpayers in the same classification."⁶⁸ When considered in light of the North Carolina Supreme Court's command that foreign stocks bear no greater burden than intrastate ones under the old intangibles tax, the result is clear: to allow even some of the foreign stocks to "retain" the intangibles tax, when all others are exempt, is forbidden.

In light of Court precedent and the importance of uniform taxation under the state Constitution, Justice Frye's reasoning provides the more complete solution to the problem. It accepts the majority's reasoning, but also contends that the North Carolina Supreme Court's holding in *Bailey v. State*⁶⁹ means that the *Fulton (on remand)* decision should have been enough notice to the Assembly to prepare for adverse judgments.⁷⁰ This is a good rule, especially when states are tempted to play a Cournot-Nash game with unconstitutionally gained revenue.⁷¹ Again, the *Fulton* rulings are unequivocal: The state must either "forgive" the tax *en masse*, levy the tax *en masse*, or some combination thereof, again *en masse*. To allow a state to use a notification statute as a method for ducking its constitutional responsibilities would tempt states to participate in game-playing. By making earlier rulings proxies for notification, the court would ensure that the Assembly both prepares for and budgets for payment of adverse judgments in these situations.

IV. CONCLUSION

After the *Smith* ruling, the General Assembly did not include the judgment in its FY 2000 budget; instead, it planned to either dip into emergency funds or

⁶⁶511 U.S. 93 (1994).

⁶⁷As the Court remarked in *Fulton*, "this . . . simply confirms our general unwillingness to 'permit discriminatory taxes on interstate commerce to compensate for charges purportedly included in general forms of intrastate taxation.'" 516 U.S. at 338 (quoting *Oregon Waste*, 511 U.S. at 105, n.8); see also *Armco v. Hardesty*, 467 U.S. 638 (1984) (holding that a wholesaling tax exemption for West Virginia manufacturers unconstitutionally discriminated against foreign manufacturers).

⁶⁸See *Hajoca Corporation v. Clayton*, 178 S.E.2d 481 (1971); see also *Roach v. City of Durham*, 169 S.E.2d 149, 151 (1933).

⁶⁹412 S.E.2d 295 (1991).

⁷⁰Indeed, given the moderately ascerbic tone of *Smith*, it is somewhat surprising that the court did not adopt Justice Frye's stricter reasoning.

⁷¹See *supra* notes 59 and 60.

request a loan to cover the expected several hundred million dollar shortfall.⁷² On the one hand, this seems to belie Justice Frye's notion that prior adverse judgments serve adequate notice of impending suits. On the other, it lends credence to the notion that the General Assembly was gambling on a favorable verdict, especially because *Fulton (on remand)* was handed down over two years ago.

The *Smith* court correctly analyzed and applied the law. The General Assembly's attempt to retain some portion of an unconstitutionally applied tax was understandable, but unacceptable in light of long traditions of equal taxation and a nationwide market. Perhaps North Carolina's lesson will be more readily digestible to states with similar tax schema.

Christopher Scott Badeaux

⁷²Eric Dyer, *Ruling: N.C. Must Give Back Intangibles Tax: The U.S. Supreme Court Says Tax is Unconstitutional Because It Discriminates Against Interstate Commerce*, Greensboro News & Record (N.C.), Jul. 2, 1999 at A1.