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## Coates' Canons Blog: Tax Day at the N.C. Court of Appeals (Part 1)

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[Update: In 2013 the Court of Appeals reversed its opinion in the Fayetteville case discussed below based on a related N.C. Supreme Court opinion. See this blog post for more details.]

The N.C. Court of Appeals celebrated tax day a few weeks later than the rest of us: on Tuesday, the judges released two interesting decisions involving local taxes. One concerned internet sweepstakes privilege license taxes levied by Fayetteville, the other focused on the denial of a property tax exemption by Cabarrus County. Although both opinions include long discussions of procedural issues that only a first-year law student could love, they both also offer some important substantive lessons.

The Fayetteville case provides some long-awaited guidance on how we can determine whether a particular privilege license tax is unconstitutionally too high. The Cabarrus County case teaches us that counties need to be careful when rejecting late property tax exemption applications.

My analysis of the Fayetteville case is below. Tomorrow I'll post again with my analysis of the Cabarrus County case.

### Internet Sweepstakes Taxes

The Fayetteville internet sweepstakes case involved the same legal issues raised in the recent Court of Appeals decision upholding the privilege license taxes levied by Lumberton, which I analyzed here. The plaintiffs in both cases were internet sweepstakes operators who challenged both the authority of North Carolina cities to single out internet sweepstakes businesses for privilege license taxes and the amount of those taxes.

Because of the similarity between the two cases, the Fayetteville court adopted without additional analysis the conclusion of the Lumberton court that North Carolina cities do indeed possess the authority to levy privilege license taxes on internet sweepstakes businesses. After two unanimous decisions on this issue, it now seems settled beyond a reasonable doubt that cities can create privilege license tax categories aimed solely at internet sweepstakes operators.

The only question that remains is exactly how high these taxes can climb before they become unconstitutional. In the Lumberton opinion, the Court of Appeals affirmed a summary judgment issued in favor of the city because the plaintiffs had not produced enough evidence to justify a trial on this question. But in this week's Fayetteville opinion, the Court of Appeals decided that three of the fourteen plaintiffs had met their evidentiary burden and therefore deserved a trial on this question.

This ruling means that unless the case is settled, several internet sweepstakes operators will have the chance to convince a judge or a jury that Fayetteville's tax of \$2,000 per location plus \$2,500 per sweepstakes machine violates the North Carolina constitutional requirement that all local taxes be "just and equitable."

It's important to remember that the Court of Appeals ruling does not mean that the Fayetteville taxes are unconstitutional. Nor does the ruling in the Lumberton case mean that Lumberton's taxes are constitutional. Each ruling focused on the narrower issue of whether the plaintiffs were entitled to a trial about whether the taxes in question were too high.

Because the Fayetteville plaintiffs produced sufficient evidence about the impact of Fayetteville's taxes on their ability to operate profitably, they earned the right to a trial. The Lumberton ruling would not prevent other sweepstakes operators in that city from earning a trial on Lumberton's taxes if they were to produce evidence similar to that introduced in the

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Fayetteville case.

So exactly how can a plaintiff prove that a particular tax is unconstitutionally too high? Prior to the Fayetteville opinion, we didn't have any clear instruction from our courts on how to interpret the 1936 amendment to the state constitution requiring "just and equitable" taxes. The Fayetteville court was forced to look at cases interpreting similar provisions from older versions of our state constitution for guidance.

The court started by taking note of the presumption that privilege licenses taxes are "reasonable and not prohibitory." In other words, we assume that all taxes are constitutional unless a taxpayer can prove otherwise.

To rebut this presumption, a plaintiff must "show the tax is so high that it amounts to a prohibition of the plaintiff's particular business, effectively eliminating all similar businesses within the city." A city cannot use the taxation power to eliminate a type of business.

To show that a tax was effectively a prohibition on a particular business, the plaintiff must show that the tax prevents the business from earning a profit. The privilege license tax should reasonably relate to the profitability of the type of business being taxed, meaning more profitable businesses can be taxed at higher rates.

Evidence of the tax's impact on other businesses similarly situated to the plaintiff will be helpful to rebut the presumption in favor of the tax. Also helpful will be evidence of a large increase in the taxes levied on the plaintiff's type of business.

If the plaintiff produces the evidence necessary to rebut the presumption in favor of the tax, the burden shifts to the city to prove that its tax is not prohibitory and therefore constitutional. The court provided a "non-exclusive" list of two ways a city can accomplish this task.

First, it can show that the tax is related to the "cost of increased police regulation" of the taxed business: more police calls to a business justify higher taxes on that business. Second, it can offer evidence that the plaintiff's inability to earn a profit is caused by poor management and not by the amount of the tax. If other businesses can pay the tax and still make a profit, then the tax must not be the plaintiff's real problem.

The Fayetteville court then applied this framework to the evidence presented by the parties and concluded that a trial was necessary. The plaintiffs had rebutted the presumption in favor of the tax, while the city had produced evidence suggesting the tax was reasonable. As a result, summary judgment was not appropriate and the issue should be resolved at trial.

What will happen if the case gets to a jury? Although the plaintiff's nominally "won" this battle, I think it is unlikely they will win the war.

The court made clear that if the city can show that other similarly situated businesses can pay the tax and still make a profit, then the plaintiffs should lose. Based what I've heard, a number of internet sweepstakes operators have paid the taxes in Fayetteville and remain in business. And other sweepstakes operators have paid similar taxes in other cities and are still in business. If so, then the taxes levied by Fayetteville must not be so high as to eliminate the opportunity for a profit and must therefore be constitutional.

But anything can happen at trial. As they say in sports, that's why they play the games. And the legal playing field could be completely changed by future appellate court decisions on these tax questions or on the more basic question of whether the state can ban these sweepstakes entirely. Stay tuned.

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