New Certainty for Interstate Business Enterprises: The New NC Combined Reporting Law

A few weeks ago, NC Governor Perdue signed HB 619, a bill designed to reduce the acknowledged unfairness in NC's enforcement of its corporate income tax laws against multistate business enterprises.

An interstate business using multiple business entities under common ownership (collectively, an "enterprise") often has some of its companies which have a taxable connection (or "nexus") with a given taxing state (like NC), and others which do not. Often, the "nexus" companies will engage in affiliate transactions with the "non-nexus" companies.

For more than a decade, business enterprises have been complaining about NC's enforcement of its discretionary authority to force "combined reporting." Some of these complaints have been addressed by the enactment of HB 619.

What is Combined Reporting?

Combined reporting situations require three preconditions:

First, you need an enterprise group of companies, some but less than all of which have nexus with a given taxing state, like NC.

Second, one or more of the "non NC" companies need to have money flowing to or from one or more of the "NC" companies – in other words, affiliated transactions. Typically the payor entity is in the taxing state, and the recipient entity is not in the taxing state.

Third, the taxing state needs to have a general rule *a prohibition against* combined/consolidated reporting – such that only the taxpayers who have a taxable connection with that taxing state have a right to file a NC tax return. The enterprise has no right to file a unitary tax return that would effectively net out the deduction created by the payment, and the income created by the receipt of the payment.

Heads, NC Won; Tails, Taxpayer Lost.

It would therefore seem to be a fair trade-off that states that do not permit such filings should not be able to require such filings. But the NC Department of Revenue (DOR) has increasingly said on audit:"Wait a minute – in-state company, you're taking a NC deduction on your payments to your affiliate located in [VA], but we don't get to tax that income that you sent out there to [VA]!"

Nevertheless, NC has long had the statutory authority to force combined reporting (to avoid that loss of income) in cases of income "distortion." The authority is vague, the standards essentially

non-existent, and NC DOR's enforcement policies were seen by many as wholly abusive, and one of the most aggressive aspects of NC taxation.

The unfairness of this situation became a central focus of Judge Tenille's critical opinion in Delhaize America, Inc. v. Lay, No. 06 CVS 08416 (Sup. Ct. Wake County) (January 12, 2011). Once he went into private practice, the NC DOR's own former Assistant Secretary of Revenue published a lengthy scholarly article which criticized the fairness of these policies. "North Carolina's Next State and Local Tax Frontier: Forced Combination," Journal of Multistate Taxation and Incentives 6 (January 2006).

So in NC, an enterprise would have no ***right*** to file a combined income tax return, but the taxing authorities could ***force*** such a result (and impose penalties for the taxpayer's failure to do so) if DOR found income distortion based upon the taxpayer's compliance with the mandatory separate return filing approach.

What HB 619 Does.

HB 619 is designed to combat this substantial discretion, which posed Due Process concerns among others.

The bill makes clear that combined reporting is discouraged in all but the clearly egregious cases.

The bill appears to effectively overturn the recent "game-changing" holding in Wal-Mart Stores East, Inc. v. Hinton, 197 N.C. App. 30, 676 S.E.2d 634 (2009), which had ruled that affiliate transactions could be "distortive" *even in cases in which the federal (IRC Section 482) standards were satisfied*, via a transfer pricing study or otherwise.

The new test for income recharacterization requires a finding that affiliate transactions either (a) are not at "fair market value" (apparently incorporating the federal transfer pricing principles) or (b) lack "economic substance."

"Economic substance" exists as long as there is a reasonable business purpose and reasonable economic effect, independent of state income tax planning (and independent of financial accounting benefits which hinge entirely upon such tax planning).

Furthermore, even if distortion is found, combined reporting is only a tool of last resort. Whenever a deduction addback (that is, denying a deduction to the company already filing NC income tax returns) is "adequate under the circumstances to redetermine State net income," the state must take this approach rather than forcing the out-of-state company to file in NC.

The bill also contains other provisions that are advantageous to businesses:

-each tax year is *separately* evaluated under the new income distortion test;

-notice and appeal procedures are prescribed for situations in which DOR wishes to force a combined return filing;

-a special apportionment provision is added for combined reporting situations;

-and taxpayer ruling requests must generally be ruled upon by the Department of Revenue within 120 days (for a fee of up to $5,000).

What HB 619 ***Does Not*** *Do.*

- It is unclear what evidence the NC DOR needs in order to support a "fact" finding that an enterprise's affiliate transactions do (or may) not pass muster.

- Similarly, NC DOR seems to retain substantial discretion in determining whether combination is necessary (e.g., addbacks would be inadequate), even though its determinations will certainly be subjected to more scrutiny than in the past.

- Finally, the bill does not resolve partisan political debate, and may not represent the settled state of the law. Though Governor Perdue voiced concerns about the fiscal impacts of the measure, the "fairness" message proved difficult to argue with, and the bill was ultimately signed. Nevertheless, certain elements within the state political system have nevertheless characterized the law as "allow[ing] multi-state corporations to create tax shelters" (a characterization which is difficult to support, given that by definition, tax shelters lack economic substance/fair pricing). "North Carolina Restricts DOR's Authority To Require Corporate Combined Reporting," BNA Weekly State Tax Highlights (July 14 2011). Governor Perdue has asked that the law's fiscal impact be monitored over time, *perhaps suggesting that the possibility that the rules might change again at some later date*. Interestingly, at the same time, NC's neighbor, SC, has enacted a Budget Bill (HB 3700) requiring the SC DOR to interpret the revenue statutes "based solely on the plain meaning of the statute's text and the legislative intent giving rise to the enactment of the statutes."

Contact Information:

If you have questions regarding this proposed rule, please contact Neill Edwards, the principal author of the alert. You may also contact the Womble Carlyle attorney with whom you usually work, or any of our Tax attorneys.