North Carolina's New Forced Combination Statute

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Over the past 10 years, the scope of the North Carolina Department of Revenue's authority to force affiliated corporations to file combined returns has become one of the most controversial aspects of North Carolina's corporate income tax laws. The statute granting this authority, G.S. 105-130.6, has been criticized in recent years for the vague standard it establishes for determining when the Department of Revenue is justified in requiring a combined return. See, e.g., Michael A. Hannah, "Forced Combination – North Carolina's Next State and Local Tax Frontier," J. Multistate Tax'n & Incentives, Jan. 2006, at 8, 10-12. The Department has also been criticized for relying on "ill-defined, unpublished guidelines" in exercising the authority granted to it under Section 105-130.6. See, e.g., Jennifer Carr, "North Carolina Plays Hide the Ball with Forced Combination Guidance," Tax Analysts, Feb. 23, 2009, at 603, 606. In the 2011 legislative session, presumably in response to this criticism, the North Carolina General Assembly repealed G.S. 105-130.6, replacing it with more detailed guidelines in new G.S. 105-130.5A. See N.C. Sess. Law 2011-390. As explained below, while this new statute creates new, taxpayer-friendly procedural limitations on the Department's ability to compel combined reporting, the substantive guidelines of G.S. 105-130.5A provide the Department with a significant amount of discretion in determining whether to require a combined report, and it is therefore unclear whether the new statute will actually provide taxpayers with the clarity the statute's proponents were seeking.

The Troublesome Old Law: G.S. 105-130.6

The predecessor statute to G.S. 105-130.6 was originally enacted in 1935, and the statute has existed in substantially its current form since 1941. See Act of May 9, 1935, ch. 371, § 318½, 1935 N.C. Sess. L. 429, 549-50; Act of Feb. 28, 1941, ch. 50, § 5(f), 1941 N.C. Sess. L. 66, 74. The most controversial portion of G.S. 105-130.6 is its first paragraph, which provides as follows:

The net income of a corporation doing business in this State that is a parent, subsidiary, or affiliate of another corporation shall be determined by eliminating all payments to or charges by the parent, subsidiary, or affiliated corporation in excess of fair compensation in all intercompany transactions of any kind whatsoever. If the Secretary finds as a fact that a report by a corporation does not disclose the true earnings of the corporation on its business carried on in this State, the Secretary may require the corporation to file a consolidated return of the entire operations of the parent corporation and of its subsidiaries and affiliates, including its own operations and income. The Secretary shall determine the true amount of net income earned by such corporation in this State.

This statute has generated two principal controversies. First, many taxpayers and practitioners have interpreted the first sentence of the statute as requiring the Department to make adjustments to intercompany pricing prior to ordering combination. Under this interpretation, the Department was first required to determine whether payments between affiliated companies exceeded the fair market value of goods or services exchanged. After concluding that intercompany payments exceeded fair market value, the Department was permitted to order a combined return only if, after reducing intercompany payments to fair market value, separate reporting still failed to "disclose the true earnings of the corporation."

The most prominent example of this argument came in Wal-Mart Stores East, Inc. v. Hinton, 197 N. C. App. 30, 676 S.E.2d 634 (2009), where the Court of Appeals summarily rejected the two-step approach to forced combinations. The Court of Appeals stated:

The language of the statute on its face does not limit the Secretary's authority to require combined reporting by mandating that he first find that the entity engaged in 'non-arm's length dealings' . . . . To the contrary, the language of the statute is broad, allowing the Secretary to require combined reporting if he finds as a fact that a report by a corporation does not disclose the true earnings of the corporation on its business carried on in this State. On its face, it does not restrict the Secretary to a finding of a particular type of transaction or dealing.
Wal-Mart Stores East, 197 N.C. App. at 39, 676 S.E.2d at 642 (citations omitted).

The second principal controversy lies in the meaning of "true earnings" under G.S. 105-130.6. If, as the Court of Appeals held, the Department can require affiliated corporations to file a combined return whenever separate returns fail to disclose their "true earnings," taxpayers and the Department must have some meaningful way of determining what true earnings are. Regrettably, the Court of Appeals in Wal-Mart failed to provide meaningful guidance on this point, though the court did attempt to define "true earnings." According to the Court of Appeals: "The essential meaning of the phrase 'true earnings' refers to the limit on state taxation found in the United States Constitution." Wal-Mart Stores East, 197 N.C. App. at 40, 676 S.E.2d at 643. Read in conjunction with the court's interpretation of the Department's authority to require a combined return, this definition of true earnings suggests, remarkably, that the Department can order combined reporting whenever a corporation's separate return produces a taxable income figure that is less than the maximum amount allowable under the U.S. Constitution.

Unfortunately, the rule of the Wal-Mart case not only appears to expand greatly the Department's ability to require combined reporting, it also fails to give taxpayers a predictable framework for determining whether their corporate and financial accounting practices might subject them to forcible combined reporting. There is no easy way to determine where "the limit on state taxation found in the United States Constitution" lies, and the U.S. Supreme Court cases cited in Wal-Mart do not (contrary to the Wal-Mart court's assertion) "discuss…the concept of 'true earnings.'" See Wal-Mart Stores East, 197 N.C. App. at 40, 676 S.E.2d at 643. Indeed, the phrase "true earnings" does not appear at all in the cases cited by the Wal-Mart court; rather, those cases discuss the scope of the "unitary business" concept, which delineates the nature of the business relationships required for a state to tax a corporation that does not have nexus with the state. See Allied-Signal, Inc. v. Dir., Div. of Taxation, 504 U.S. 768 (1992); Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425 (1980).

In the 2010 legislative session, the General Assembly responded to criticism of the Wal-Mart decision and the Department's administration of G.S. 105-130.6 by revising the statute to add a new subsection (d), which authorized, but did not require, the Department to "adopt rules . . . that describe facts and circumstances under which the Secretary will require a corporation to file a consolidated or combined return." G.S. 105-130.6(d) also provided that the adoption of such rules "does not limit the Secretary's authority to require a consolidated or combined return under sets of facts and circumstances not described in the rules." Because the Department presumably had the power to promulgate interpretive rules under G.S. 105-130.6 prior to this amendment, the net effect of the new subsection (d) was to provide that any list of facts and circumstances supporting combination published in an administrative rule would be per se nonexclusive. As a result, this revision did little, if anything, to promote clarity in the arena of forced combinations.

The New Law: G.S. 105-130.5A

On June 30, 2011, Governor Perdue signed into law House Bill 619: "An Act to Specify the Secretary of Revenue's Authority to Adjust the Net Income of a Corporation or to Require a Corporation to File a Combined Return." As noted above, this bill repealed the troublesome G.S. 105-130.6 and enacted a new G.S. 105-130.5A. Significantly for taxpayers currently involved in corporate audits, the repeal of G.S. 105-130.6 and enactment of G.S. 105-130.5A will apply only to taxable years beginning on or after January 1, 2012. See N.C. Sess. Law 2011-390, § 8; N.C. Sess. Law 2011-411, § 8.(b).1

G.S. 105-130.5A, when it becomes effective, will make several significant changes to North Carolina law on forced combinations. Procedurally, the statute introduces several new protections for taxpayers. First, before ordering the filing of a combined return, the Department is required to give notice to the taxpayer that it has reason to believe that a separate return will not result in an accurate report of the taxpayer's net income in North Carolina. The taxpayer must then be given 90 days to provide any additional information requested by the Department. G.S. § 105-130.5A(a). After receiving information from the taxpayer, the Department is required to make a factual finding that a combined return is required under the substantive standards described below before giving the taxpayer an additional 90 days to file the combined return. G.S. 105-130.5A(c).

Within 90 days after making an assessment on the basis of a combined return, the Department must provide the taxpayer with a "written statement containing detail of the facts, circumstances, and reasons for which the Secretary has found as a fact that the corporation did not accurately report its State net income." G.S. 105-130.5A(d). Finally, if the Department proposes to require a combined return of fewer than all members of a unitary group, the taxpayer can demand that the combined return include all members of the unitary group, thereby preventing the Department from cherry-picking for a combined return only those corporations whose inclusion will result in an increase in North Carolina taxable income. These procedural hurdles appear to be a response to criticisms of the Department's prior refusals to provide sufficient justification for requiring combined reporting, which, in one commentator's view, "effectively denie[d] the taxpayer a meaningful opportunity to refute the [Department's] contention." Hannah, supra, at 13. In this regard, the procedural changes enacted by G.S. 105-130.5A are a significant step forward in North Carolina law.

Substantively, the new statute makes two significant changes. First, the statute adopts a version of the taxpayer's position in the Wal-Mart case, requiring the Department to attempt to resolve income distortions through adjustments to intercompany payments before ordering a combined return. See G.S. 105-130.5A(b). Notably, however, because the statute authorizes the Department to "add…back" or "eliminate" intercompany transactions, the Department will likely be able to reach a tax result substantially similar to that of a combined return without actually ordering a combination. (In a combined return, intercompany transactions are eliminated entirely. Differences between taxable income on a combined return versus a return that is adjusted by "adding back" or "eliminating" intercompany transactions could arise as a result of differences in apportionment factors for related entities under Section 105-130.4 or as a result of the Department eliminating some, but not all, intercompany transactions.)

Second, the new statute adopts a two-prong standard for determining when an adjustment to intercompany transactions or a combined return is justified. Under Section 105-130.5A, the Department may adjust a corporation's net income if "the corporation's intercompany transactions lack economic substance or are not at fair market value." G.S. 105-130.5A(b). The fair market value standard mirrors the federal standard for adjusting intercompany transactions between domestic and foreign members of a consolidated group under Code § 482, and in fact G.S. 105-130.5A(g) provides that the Department "shall apply the standards contained in the regulations adopted under section 482 of the Code."

If the statute had stopped here, it would have amounted to a complete legislative victory for the taxpayer's position in the Wal-Mart case. However, G.S. 105-130.5A also allows the Department to make intercompany pricing adjustments or order combined reporting if it finds that intercompany transactions lack "economic substance." The new statute defines economic substance as follows:

A transaction has economic substance if (i) the transaction, or the series of transactions of which the transaction is a part, has one or more reasonable business purposes other than the creation of State income tax benefits and (ii) the transaction, or the series of transactions of which the transaction is a part, has economic effects beyond the creation of State income tax benefits.

G.S. 105-130.5A(f). This definition of economic substance tracks the federal codification of the economic substance doctrine in Code § 7701(o). Presumably, then, North Carolina courts applying this statute in the future will look to federal economic substance case law for guidance. G.S. 105-130.5A goes on to make several refinements to this general definition of economic substance:

- "[R]easonable business purposes and economic effects include ... any material benefit from the transaction other than State income tax benefits."
- A taxpayer may establish a transaction has economic effects other than tax benefits by "demonstrating material business activity of the entities involved in the transaction."
- State income tax benefits that are "consistent with legislative intent" can be considered in determining whether a transaction has business purpose and economic substance.
- "Centralized cash management of an affiliated group . . . shall not constitute evidence of an absence of economic substance."
- A financial accounting benefit cannot be taken into account in determining whether a transaction has a reasonable business purpose if the origin of the benefit is a reduction of state income taxes.

The reasonably well-defined "economic substance" standard in G.S. 105-130.5A represents a clear improvement over the essentially undefined "true earnings" standard of G.S. 105-130.6. (The new statute scrupulously avoids the phrase "true earnings," presumably in an attempt to foreclose any future reliance on the Court of Appeals' problematic opinion in Wal-Mart.) The adoption of an economic substance doctrine also allows North Carolina courts to rely on a fairly extensive body of federal case law while the North Carolina law is in its infancy. As commentators and Congress have noted, the federal case law suffers from its own inconsistencies and uncertainties (see, e.g., Staff of Jt. Comm. on Tax'n, 109th Cong., Options to Improve Tax Compliance and Reform Tax Expenditures, at 15-16 (2005), available at this link), but it at least provides some direction for taxpayers, the Department, and the courts in determining whether an adjustment to income or combined reporting is permitted under G.S. 105-130.5A.

Conclusion

From a taxpayer's perspective, G.S. 105-130.5A is, without question, an improvement over G.S. 105-130.6, especially after the Wal-Mart decision. Corporate taxpayers can now count on new procedural protections in defending audits of intercompany transactions, and taxpayers and practitioners have at least an outline of the substantive principles that will be applied in determining whether intercompany transactions and separate reporting will be respected by the Department. Whether the new statute will provide the clarity the legislature and the business community seem to desire, however, remains to be seen. After all, the decision to order a combined return remains in the hands of the Department, which is instructed by statute to apply an "economic substance" standard that, while reasonably well-defined, still turns on questions of reasonableness and legislative intent. As a result, forced combination litigation will likely continue, with the battlefront likely shifting from the scope of the Department's combination authority to questions of whether particular transactions have economic substance.

End Notes

1. As originally enacted, House Bill 619 provided that G.S. 105-130.6 was repealed effective Jan. 1, 2012 without stating which taxable years would be affected by the repeal. The enactment of G.S. 105-130.5A, on the other hand, was made effective only for assessments proposed for taxable years beginning on or after Jan. 1, 2012. As a result, it appeared the Department's combination authority would be retroactively eliminated for all open tax years on Jan. 1, 2012. On Sept. 15, 2011, the General Assembly corrected this technical error in Session Law 2011-411, which clarifies the legislature's intent to make both the enactment of G.S. 105-130.5A and the repeal of G.S. 105-130.6 effective only for taxable years beginning on or after Jan. 1, 2012.