
North Carolina adopts rules regarding Secretary's authority to adjust income or require combined returns

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In brief

The North Carolina Department of Revenue adopted regulations regarding the Secretary of Revenue's authority to adjust net income or require combined returns when intercompany transactions lack economic substance or are not at fair market value. The regulations are promulgated in response to H.B. 619, enacted 6/30/11, conferring combination authority upon the Secretary ([click here](#) for more on H.B. 619) and S.B. 824, enacted 6/20/12, requiring the Department to adopt rules before the Secretary may exercise such authority ([click here](#) for more on S.B. 824). The regulations are applicable for taxable years beginning on or after January 1, 2012. [Secretary's Authority to Adjust Net Income or Require a Combined Return, 17 NCAC 05F.0100, North Carolina Department of Revenue, effective 1/31/13]

Our understanding is that the final adopted regulations have been submitted to the North Carolina Office of Administrative Hearings (OAH) for publication in the North Carolina Register. The regulations should soon be available on the OAH website.

In detail

The following is an overview of the regulations.

Sec. .0100 - General. The regulations provide definitions of terms and phrases for purposes of analyzing the Secretary's authority to require combined returns. Among these definitions, "unitary business" means one or more related business organizations where there is a unity of ownership, operation and use, or interdependence of functions.

The regulation also includes the definition of "economic position," meaning the status of a taxpayer's assets, liabilities, and equity (whether those items are actual, contingent or potential) and their interrelationship to one another.

Sec. .0200 - Economic Substance. A transaction has economic substance if (1) it has one or more reasonable business purposes other than the creation of State income tax benefits and (2) it has economic effects beyond the creation of

State income tax benefits. The regulations clarify that the taxpayer has the burden of proving that a transaction meets both prongs of this test.

The regulations provide that to prove reasonable business purpose taxpayers must show through contemporaneous documentation that:

1. The business purpose asserted was valid and realistic;

2. The transaction was a reasonable and realistic means to accomplish the asserted business purpose;
3. Evidence exists that shows the taxpayer took steps to achieve the asserted business purpose; and
4. The asserted business purpose is commensurate with the tax benefits claimed.

In analyzing the economic effect of a transaction, or series of transactions of which the transaction is a part, the regulations provide that the Secretary shall look at the effect on the taxpayer and the aggregate economic effect on the parties to the transaction. To prove economic effect taxpayers must show by objective evidence that:

1. A reasonable likelihood of economic benefit, other than State income tax benefits, from the transaction existed at the time the transaction was initiated; and
2. The transaction affected the taxpayer's business position apart from the State income tax benefits.

The regulations provide basic principles of the economic substance doctrine and a list of facts and circumstances to consider when determining whether a transaction has economic substance. Such factors include whether the transaction was a reasonable means to accomplish the asserted purposes, whether the method of determining the amount of payment is an industry practice, the parties who presented the ideas, drafted and negotiated the agreements concerning the transaction, whether the intercompany transaction resulted in a circular cash flow, and the non-tax benefits obtained by the taxpayer as a result of the transaction.

The regulation also clarifies that state income tax benefits resulting from a

transaction are considered in determining whether a transaction has reasonable business purpose and economic substance "when the state income tax benefits are consistent with legislative intent."

A note on centralized cash management systems

The regulations provide that the existence of a centralized cash management system is not conclusive evidence that a transaction lacks economic substance. However, if the transaction results in the creation of unreasonably excessive interest expense when compared to industry practice, shifting of assets, or the reclassification of income as nonapportionable or nonallocable, the transaction may be deemed to lack economic substance.

Sec. .0300 - Fair Market Value.

The regulations provide that the standards for determining whether a transaction is made at fair market value will be the same as those adopted under Internal Revenue Code Sec. 482 and any federal or state case law developed under such section. The Secretary may also consider any transfer pricing study provided by the taxpayer, but such study is not, in and of itself, sufficient to establish that a transaction was made at fair market value.

Sec. .0400 - Adjustments. If intercompany transactions are found to lack economic substance or not to be at fair market value, the regulations provide that the Secretary may make adjustments to such transactions, including:

1. Disallowing deductions in whole or in part;
2. Attributing income to related corporations;
3. Disregarding transactions; and

4. Reclassifying income as apportionable or allocable.

Sec. .0500 - Combined Returns. In general, the regulations contain the methodology and procedures to follow when a combined return is required or permitted. The regulations provide that the starting point is the federal taxable income of the pro forma 1120 for each corporation "as if" each were not part of a federal consolidated 1120. Intercompany transactions are eliminated. Combined groups will use the standard three factor apportionment formula to determine income apportioned to North Carolina. All sales into North Carolina by entities within the combined group shall be included in the sales factor numerator. When more than 50% of a group's combined income subject to apportionment is generated from a business activity subject to special apportionment provisions, such provisions will be applied to the income of the entire group.

If the taxpayer believes that the statutory method that otherwise applies to the combined group is disproportionate to its business attributable to the State, the taxpayer may propose, and the Secretary shall consider, an alternative method of apportionment.

In computing North Carolina net income subject to tax, a combined group may utilize net economic losses incurred by a taxpayer before becoming a member of the combined group. However, net economic losses remain the tax attribute of the member that generates such losses.

Net economic losses incurred by the combined group shall be allocated among the members of the group that reported losses on their pro forma 1120s. The amount allocated to each member is determined by dividing that member's loss by the total losses

of all combined group members in that tax year.

With respect to credits, the regulations provide that a combined group's income tax may be reduced by tax credits earned by a member of the group, but not fully used before that entity became a member of the group. However, any unused credit that may be carried forward remains with the member of the group that earned it.

Sec. .0600 - Franchise Tax Return. The regulations provide that

each corporation doing business in North Carolina will continue to file a separate franchise tax return, unless the Secretary authorizes a combined group to file a combined franchise tax return.

The takeaway

The final regulations are substantially similar to the proposed regulations issued in October 2012. Notable changes from the proposed regulations include: (1) providing a definition of "economic position;" (2)

clarifying that state income tax benefits will be considered by the Secretary "when the State income tax benefits are consistent with legislative intent; (3) removing "adjusting the computation of a factor used in the apportionment formula" from the adjustments the Secretary may make under section .0400; and (4) providing that under certain circumstances, "the taxpayer may propose, and the Secretary shall consider, an alternative method of apportionment."

Let's talk

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