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## *North Carolina draft amended legislation would limit Secretary's forced combination powers*

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The North Carolina General Assembly recently proposed legislation to clarify when the North Carolina Department of Revenue may require combined reporting. Specifically, a discussion draft version of Senate Bill 739 released by the Senate Finance Committee proposes modifications to N.C.G.S. 105-130.6 that would limit the Secretary's authority to require a combined return to those instances where other reasonable means to accurately report the taxpayer's net income are ineffective and would create a rebuttable presumption that a combined return is not required if a corporation and members of its unitary group "comply with the economic substance doctrine," among other changes. [[S.B. 739, referred to Committee on Finance, 4/20/11](#)]

### **Background**

In 2010, the North Carolina General Assembly enacted a budget bill (S.L. 2010-31), providing that taxpayers may only file on a combined or consolidated basis if: (1) directed to do so by the Secretary; (2) their facts and circumstances meet those specified in a permanent rule adopted by the Secretary; or (3) the taxpayer requests and receives from the Secretary written guidance directing it to file on a consolidated or combined basis. The legislation directed the Secretary to follow the administrative process in adopting rules with respect to consolidated and combined returns.



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The North Carolina Department of Revenue issued a draft proposed regulation in February 2011 that requires combined reporting upon the satisfaction of certain requirements, including situations where reporting on a separate basis does not disclose the true earnings of the corporation on its business carried on in the state. ([Click here for a summary of the draft proposed regulation](#))

In particular, under the "true earnings" test, a combined return would only include those corporations in the unitary business whose intercompany transactions cause true earnings of the business carried on in the state not to be disclosed. Intercompany transactions in excess of cost would indicate that true earnings are not reported, regardless of any transfer pricing study in support of the charges.

### **Proposed Changes to Limit Secretary's Power**

In response to taxpayer confusion over when the Secretary might exercise discretionary combination powers under the draft proposed regulation, the North Carolina General Assembly proposed modifications to N.C.G.S. 105-130.6. The bill is currently in the Senate Finance Committee, which has modified the original proposed changes by rewriting the statute. Comments on the draft legislation are currently being accepted for consideration.

The draft legislation allows the Secretary to compute taxpayer net income by adjusting intercompany transactions for charges between affiliated members that are in excess of fair market value, including requiring a combined return. In determining whether intercompany transactions are in excess of fair market value, the Secretary is directed to apply the standards contained in Treasury Regulations adopted under I.R.C. Sec. 482. The Secretary may require a combined return only if other reasonable means to accurately report net income properly attributable to the state are ineffective. Significantly, the draft legislation creates a rebuttable presumption that a combined return is not required if the corporation and members of its affiliated group conducting a unitary business "comply with the economic substance doctrine" as codified under I.R.C. Sec. 7701(o), but with the term "State income tax effects" substituted for the term "Federal income tax effects."

### **Other Changes**

The draft legislation would make other changes to the Secretary's power to require combined reporting, including:

- The Secretary shall request taxpayer information if he believes that income has not been properly reported to the state, and the information must be provided to the Secretary within 90 days.
- If the information submitted by the taxpayer so indicates, the Secretary shall provide the taxpayer with a written statement detailing his determination that the taxpayer did not accurately report its net income properly attributable to the state, and the Secretary's proposed resolution.
- If the Secretary requires a combined return, the taxpayer has 90 days to file, although filing does not mean the taxpayer agrees that combination is proper.

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- The combined return must include the taxpayer and all affiliates that are conducting a unitary business. An affiliate is defined by 50% direct or indirect common ownership.
  - Certain entities are excluded from the combined report, including: corporations not required to file a federal income tax return; certain insurance companies; corporations exempt from tax under IRC § 501; S corporations; foreign corporations as defined in I.R.C. Sec. 7701, other than a domestic branch thereof; or a corporation with at least 80% of its gross income being active foreign business income.
  - Taxpayers can request advice regarding whether a combined return would be required from the Secretary, who must respond within 120 days.
  - Penalties are prohibited under the proposed law except as authorized.
  - The Secretary may not require a combined return except as provided under the proposed law.
  - The Secretary must adopt rules which describe facts and circumstances under which combined filing will be required no later than December 31, 2011.

### ***PwC Observes***

"While it is encouraging that this draft language would provide clarity around when the Secretary may exercise his authority to require combined reporting, some may view the proposal as not going far enough," observes Stu Lockerbie, PwC State and Local Tax Director in Charlotte. "Of course, this draft was released by the Senate Finance Committee for the express purpose of garnering taxpayer input, and thus now is the time to suggest any improvements to this already very positive action taken by the Committee."

"One area that might be a focus of amendments is the draft's use of the federal, codified economic substance doctrine for purposes of creating a rebuttable presumption against forced combination. While taxpayers may assert valid business purposes and economic substance for their structures and transactions, the federal codification leaves many questions unanswered and could introduce a measure of uncertainty regarding its application."

"Also notable, this draft appears to require the combination of all unitary entities, from 'A to Z', rather than just the entities involved in the alleged distortive activities. This would be a change from current practice by the Secretary."

"With all this said, this draft is a *huge* step in the right direction, and taxpayers are encouraged to provide input to the Senate Finance Committee either directly or through their representatives and taxpayer organizations."

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