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Enacted North Carolina legislation sets parameters for combination

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Authored by: Adam Weinreb

On June 30, 2011, the North Carolina Governor Beverly Perdue signed legislation that allows the Secretary of Revenue to make adjustments or require combination when intercompany transactions lack economic substance or are not at fair market value, applicable to assessments proposed for taxable years beginning on or after January 1, 2012. [[H.B. 619](#), enacted 6/30/11]

New authority to make adjustments, force combination

House Bill 619 provides new rules for when the Secretary believes that a corporation fails to accurately report its net income properly attributable to business carried on in the State through transactions between members of an affiliated group that lack economic substance or that are not at fair market value. In such an instance, the Secretary may, upon written notice, require the corporation to provide within 90 days any information reasonably necessary to determine whether the Secretary's beliefs regarding the transactions are accurate.

Upon review of the information provided, if the Secretary determines that the intercompany transactions lack economic substance or are not at fair market value, it may redetermine the corporation's net income properly attributable to the State by: adding back, eliminating, or otherwise adjusting the intercompany transactions. If



such adjustments are not adequate the Secretary may require the corporation to file a combined return that includes all members of its affiliated group (regardless of whether the members are doing business in the state) that are conducting a unitary business. The legislation requires the Secretary to: (1) consider and use any reasonable method proposed by the corporation for redetermining the corporation's net income; and (2) apply I.R.C. Sec. 482 standards in determining whether transactions between affiliated group members are conducted at fair market value.

If the Secretary determines that combined filing is required, it may require the corporation to file a combined return within 90 days of written notice. The submission of the combined return will "not be deemed to be a return" or construed as an agreement by the corporation that an assessment based on the combined filing is correct or that additional tax is due by the 90 day deadline for submitting the return. The legislation requires the Secretary to issue a proposed assessment or issue a refund upon a redetermination of a corporation's State net income via an adjustment or the requirement to file a combined return. Such assessment or refund must follow the procedures currently in place. Corporations that do not timely file a combined return are subject to existing penalties under N.C. Gen. Stat. Sec. 105-236(a)(3). Penalties pursuant to an assessment related to a combined return are limited to those set out in Sec.105-236(a)(5)f, which deal specifically with combined and consolidated filing.

The legislation allows for the combination of less than all members of a unitary group, but the Secretary cannot mandate such combination without the corporation's consent. A combined return cannot include: a corporation not required to file a federal income tax return; a qualified insurance company (other than a captive insurance company); a tax-exempt corporation under I.R.C. Sec. 501; an S corporation; a foreign corporation under I.R.C. Sec. 7701 (other than a domestic branch); a partnership, limited liability company, or other entity not taxed as a corporation; or a corporation with at least 80 percent of its gross income from all sources during tax years being active foreign business income under I.R.C. Sec. 861(c)(1)(B) as in effect as of July 1, 2009. The combined State net income of the corporation and members of the affiliated group must be apportioned by use of a formula that accurately reports the State net income property attributable to the corporation's business carried on in the State and which fairly reflects the formula applicable to the corporation and each member of the affiliated group included in the combined return.

Under the legislation, economic substance exists if the transaction, or the series of transactions of which the transaction is a part, has (i) one or more reasonable business purposes other than the creation of State income tax benefits and (ii) economic effects beyond the creation of State income tax benefits. Reasonable business purposes and economic effects include, but are not limited to, any material benefit from the transaction other than State income tax benefits deemed not allowable. If State income tax benefits resulting from a transaction are consistent with legislative intent, such benefits must be considered in determining whether such transaction has business purpose and economic substance. Centralized cash management of an affiliated group does not constitute evidence of an absence of economic substance. Notably, achieving a financial accounting benefit must not be

taken into account as a reasonable business purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of State income tax.

An affiliated group is defined as a group of two or more corporations or noncorporate entities in which more than 50 percent of the voting stock or ownership interest of each member is owned or controlled (directly or indirectly) by a common owner or by one or more members. The existence of an affiliated group cannot be construed to limit the Secretary's authority to otherwise adjust intercompany transactions. If the Secretary makes an adjustment or requires combined filing, the Secretary must provide the corporation with a written statement explaining how the corporation did not accurately report income properly attributable to the State and the proposed method for computing the corporation's net income within 90 days of issuing an assessment. The legislation allows a corporation to request that the Secretary provide specific advice on whether a redetermination of the corporation's State net income or combined filing would be required based on a certain set of facts and circumstances. Such advice must be provided within 120 days of the request.

If the corporation appeals a final determination by the Department of Revenue to the Office of Administrative Hearings, the administrative law judge must review de novo (i) whether the separate income tax returns filed fail to report State net income properly attributable to the corporation's business carried on in the State through the use of intercompany transactions that lack economic substance or are not at fair market value between members of an affiliated group of entities; (ii) whether the Department's means of determining the corporation's State net income are appropriate means; and (iii) if adjustments other than requiring the corporation to file a return on a combined basis are adequate under the circumstances.

The legislation bars the Secretary from making any adjustments pursuant to this new law that limit a corporation's options for reporting royalty payments under GS 105-130.7A, and directs that the Revenue Laws Study Committee review the law and recommend any changes needed, including the extent to which the law should apply to pending assessments and requests for refund.

PwC observes

"The legislation reflects a considerable amount of work by interested parties, including the Council On State Taxation, practitioners, taxpayers, legislators and the Department of Revenue and is the most significant piece of North Carolina corporate tax legislation in recent memory," observes Stu Lockerbie, SALT Director with PwC in Charlotte.

"The legislation provides guidance and parameters regarding combination where there had been none. Currently, there are many taxpayers under a forced combination agreement with the Department of Revenue. The agreements typically include language stating that the terms are subject to any future legislative changes impacting the Secretary's authority to combine. H.B. 619 provides ample opportunity for taxpayers to review those documents to determine if breaking combination is a possibility."

For more information, please do not hesitate to contact:

<i>Stu Lockerbie</i>	<i>(704) 344-4133</i>	<i>stu.lockerbie@us.pwc.com</i>
<i>Claudia Smith</i>	<i>(704) 347-1688</i>	<i>claudia.smith@us.pwc.com</i>
<i>Adam Weinreb</i>	<i>(646) 471-4409</i>	<i>adam.weinreb@us.pwc.com</i>

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