Revenue Laws Study Committee
September 5, 2006

Remarks by Chuck Neely
Re Corporate Income Tax Combined/Consolidated Returns

COST (Council on State Taxation) is a nonprofit trade association based in Washington, D.C. Founded in 1969 as an advisory committee to the Council of State Chambers of Commerce, it has 580 members - major corporations engaged in interstate and international commerce, a majority of which do business in NC. COST's objective is to promote equitable and nondiscriminatory state and local taxation of businesses which operate in many different jurisdictions.

On a personal note, I have practiced in the area of state and local tax litigation for the past 25 years, and have personal knowledge of the issues the Committee is reviewing today.

At the outset, I should note that COST has no position on whether NC should adopt a mandatory unitary combined taxation system. The members of COST have different views on this issue. However, it is appropriate to note that there are many technical issues which will have to be dealt with if the Committee decides to take up this issue, and it can expect the discussion to be controversial.

The purpose of my appearance today is to discuss the use by the NC DOR of the remedy of forced combination of tax returns under G.S. 105-130.6, a statute enacted in the late 1930s and early 1940s.

Although my remarks might seem critical of our DOR, they are not intended to. I have worked with the staff at the DOR for many years and they are highly competent and professional. They do a lot with limited resources. However, they are forced to work with a statute which is unclear and poorly drafted. (I've spent the last 18 months studying this statute and its legislative history - and am still puzzled by some of its language.)

NC is a separate entity tax return filing state. Every corporation is required by NC law to file a separate tax return, and cannot file a consolidated return. (At federal level, affiliated taxpayers may file a consolidated return if 80% of their shares are owned by the parent). Even if a corporation is a subsidiary or affiliate of

a major multinational, and the parent has 100 subsidiaries doing business in NC, each has to file separately.

G.S. 105-130.6 was designed to allow the Secretary to force a corporation to file what the statute calls a “consolidated return” if the Secretary doesn't think the separate tax return filed discloses the “earnings of the corporation on its business carried on” in NC. As best as we can determine, its use has been rare until the last two years. There are no reported cases. There are only a couple of Secretary's decisions, and they don't really begin to define when consolidation can occur.

The statute first requires the elimination of payments between corporate affiliates that are “in excess of fair compensation” “in all intracompany transactions.”

Then the taxpayer can be compelled by the Secretary to file a “consolidated return” of all of its affiliates – “parent, subsidiaries and affiliates.”

Then the Secretary determines “the true amount of net income” earned in NC by the corporation.

If the corporation doesn't file “a consolidated return” within 60 days, substantial penalties can be assessed, perhaps up to 60% of the tax.

The taxpayer can challenge the Secretary's findings but “the findings and conclusions of the Secretary shall be presumed correct” (which is standard with DOR assessments) but they “shall not be set aside unless shown to be plainly wrong,” a much higher burden of proof on the taxpayer than any other NC tax statute imposes.

None of the statutory terms are defined.

The statute uses both “consolidated” and “combined” terminology. These terms have different meanings – DOR assessments also intermingle the terms.

The Secretary has refused to promulgate regulations to explain the statute, because, as he told a group of taxpayers in Charlotte earlier this year, and stated again this morning, he believes that would just allow taxpayers to plan around his regulations.

In addition to the problems caused by the unclear nature of the statute and the lack of regulations, the DOR has not followed the statute and has applied it inconsistently.

a) When the DOR has used combination, not all entities have been combined.

b) In some audits, the DOR seems to have picked and chosen who to combine, and it appears that in doing so, the audit staff has tried to maximize taxes. (i.e., the DOR has combined "winners," but not "losers".)

c) Taxpayers have not been given the opportunity to file a consolidated return and have been heavily penalized, in violation of the statute.

In addition to the foregoing, the basic problem is that the statute is unclear in some particulars, and taxpayers and DOR have been left to guess at its meaning.

Further, the terminology used is not consistent with current day usage of the terms "consolidation" and "combined."

There are no standards set forth in the statute as to when it is appropriate to consolidate or combine and as noted above, the DOR not promulgated guidance to the use of the combination statute. To further muddy the waters, the DOR purports to rely for its authority to combine on G.S. 105-130.15 and .16, neither of which discuss combination or consolidation.

It is unclear how the first sentence in G.S. 105-130.6, which requires adjusting intercompany transactions in excess of fair compensation, plays into the rest of the statute. Must the DOR first adjust intercompany transactions, as we think was intended, or can the first sentence be ignored, as the DOR apparently believes?

There is a harsh burden of proof on taxpayers, unlike the rest of NC revenue laws which merely give the DOR a presumption of correctness, and the burden is then on the taxpayer to prove by greater weight of the evidence that an assessment is wrong.

As a result, taxpayers have no way to know how to structure and operate a business in a way that doesn't leave them subject to forced

consolidation/combination, leading to tremendous uncertainty in the business community about how to operate in NC.

Counsel to the NCDOR has contended that the courts can work all of this out.

The problem is, the courts will have the same problem taxpayers have in understanding and applying statute.

There is a large cost to litigate.

There is substantial uncertainty to litigation.

This uncertainty promotes an atmosphere in which NC is perceived on a national basis as unfair to taxpayers.

Clearly, if a taxpayer has entered into a tax sham, (something designed only to achieve tax savings with no business purpose or no economic substance, the DOR needs a clear remedy to attack the sham. However, reliance on an unclear statute with no standards and with inconsistent application of the statute is unfair.

Regardless of any consideration the Committee may give to the issue of mandatory combination, COST respectfully requests the Revenue Laws Study Committee - and then the General Assembly - to clarify NC statutes to indicate what the legislative intent is and to provide an adequate remedy for DOR to use and a fair remedy that taxpayers will understand.