MEMORANDUM

TO: Senator Robert Rucho, Co-Chair, Revenue Laws Study Committee
Representative Julia Howard, Co-Chair, Revenue Laws Study Committee
Representative Daniel McComas, Co-Chair, Revenue Laws Study Committee

FROM: North Carolina Chamber of Commerce, North Carolina Retail Merchants Association and Council on State Taxation

DATE: January 30, 2012

RE: DOR Directive CD-11-01

Directive CD-11-01 explains the Secretary's authority to combine and the standards which the Department will follow in using its forced combination remedy under G.S. 105-130.6, G.S. 105-130.15 and G.S. 105-130.16, for tax years beginning before January 1, 2012. It also explains its authority and the standards it will follow under new G.S. 105-130.5A, enacted by HB 619 in 2011, to adjust intercompany transactions or require a corporation to file a combined return for tax years beginning on or after January 1, 2012.

The Directive responds to criticism by the North Carolina Business Court of the Department under previous Secretaries for its failure to provide guidance in the area of forced combination, and to a legislative invitation in 2010 to provide guidance by following the rule making process contained in the North Carolina Administrative Procedures Act. While the new Directive represents a laudable effort by the Department to provide, for the first time, transparency in this hotly disputed area of North Carolina tax law, there are three major areas of concern with the Directive:

I. The Directive does not alleviate taxpayer concerns about certainty in taxation.

A. It leaves the large majority of multistate corporate taxpayers (those who did not settle with the Department during its 2009 Resolution Initiative, or since that time) to grapple with two different tax regimes – one regime for tax years prior to January 1, 2012 and the other regime for tax years thereafter.

B. Further, under both regimes, the Directive lists 25 factors the Department will consider in analyzing transactions, but states as a preface to this list: "That a factor is not included on this list does not mean that it will not be considered or is not relevant." Therefore, taxpayers are still left to guess what factors will ultimately be important to the Department's decision, resulting in continued uncertainty about how their business operations will be taxed in North Carolina.

II. The Directive erroneously interprets the legislation passed by the 2011 session of the General Assembly and by prior sessions of the General Assembly, significantly misstating the law.

III. Publication of the Directive without undergoing formal rule making violates the North Carolina Administrative Procedures Act and the North Carolina Revenue Laws. The failure of the Department to undergo formal rule-making resulted in the erroneous interpretations of North Carolina law which are discussed below and results in the Directive being unenforceable.

I. The Directive does not alleviate taxpayer concerns about certainty in taxation.

A) <u>The Directive unnecessarily creates different tax regimes for the same taxpayers for different periods of time.</u>

Taxpayers and the Department are confronted with the prospect of spending significant resources negotiating and litigating under an unclear law (G.S. 105-130.6) which has been repealed and which is dramatically different from the new law, which provides clear standards. Since G.S. 105-130.6 has no definition of "true earnings," and case law has failed to provide any clear explanation of the term, the Department could have drafted its Directive in such a way as to import the standards of the new legislation into the Department's application of the old statute, allowing the development of a more consistent and useful body of precedent and providing much needed certainty to taxpayers.

The impact of these vastly different standards on taxpayers should not be underestimated. <u>Taxpayers can operate with no changes to their business operations, yet still face forced combination under one set of standards in the Directive, but not under the other.</u> Although reform was badly needed and the new law far surpasses the old, it simply does not make sense to have two different tax regimes complicating compliance and enforcement. While we recognize that the statutory language has changed, the Department could have crafted combination standards for prior years that more closely followed the standards under the new law. We believe it has the clear statutory authority to do so.

Depending upon whether the year in question falls under the old statute or the new, the following substantial differences may occur under the Directive:

1) <u>Entities subject to combination</u>. The Department contends in the Directive that it may combine less than a full unitary group under the old statute, while a full unitary combination is required under the new statute.

The Department's legal authority to exclude certain members of the unitary group once the Department has determined that a combined return must be filed is questionable. As articulated by the U.S. Supreme Court in *Mobil Oil Corp. v. Comm'r of Taxes,* 445 U.S. 425

(1980), "the linchpin of apportionability in the field of state income taxation is the unitary business principle." If the Department requires related companies to file a combined corporate income tax return, then it must respect the Constitutional restriction on its authority to tax non-unitary income and its corollary, a restriction on its authority to exclude unitary income and losses. If a combined return is required, the failure to include in the combined group all companies operating the unitary business could itself cause a distortion of true earnings.

The lack of a requirement to include all unitary affiliates in the North Carolina combined return gives the Department unwarranted discretion to selectively choose entities for the combined group based on income/loss profiles, resulting in the potential for "cherry picking," in which only those corporations are combined whose combination will result in an increase of North Carolina tax. Further, it also creates unpredictability for taxpayers on a year-to-year basis. Under the limited circumstances in which forced combination might be warranted, the inclusion of all unitary affiliates would ensure fairness and a level playing field for both the taxpayer and the Department and help ensure that "true earnings" are reported to the state.

2) Treatment of fair market value transactions between affiliated entities. Although the Directive acknowledges the new law's requirement that compliance with IRC section 482 transfer pricing standards will satisfy the new law's fair market value standards for transactions between related entities, the Department continues to take the position that intercompany transactions in excess of cost, even if they are supported by transfer pricing studies, are to be treated with suspicion. The new Directive provides, "intercompany transactions in excess of cost may indicate that net income attributable to the State is not disclosed..."

The use of the Directive's "excess of cost" standard for determining that true earnings are not reported has no equivalent in the laws of other states, the Internal Revenue Code, or in international tax treaties. Independent companies do not engage in transactions at "cost." Requiring related companies to engage in transactions at "cost" in order to avoid forced combination itself would *distort* true earnings. The Directive's standard turns existing state, federal, and international tax standards on their heads. Indeed, other states, the United States, and foreign countries *require* a fair profit on intercompany transactions. (*E.g.*, IRC Sec. 482.) In fact, if separate corporations were to apply the Directive's excess of cost standard, they would be in violation of the IRC and the tax laws of North Carolina and other states.

The "excess of cost" standard does not relate to "true earnings," as required by old North Carolina law under G.S. 105-130.6, and it casts a net so broad as to sweep in virtually all corporations doing business with affiliates. Such a standard is not legal under North Carolina law.

The "excess of cost" standard is contrary to the relevant provisions of North Carolina law, including G.S. 105-130.5, 105-130.6, and 105-130.16, all of which make reference to "fair compensation" and/or "fair profit," and G.S. 105-130.2(5c) which uses federal taxable income as the starting point for determining State net income, thereby directly incorporating into North Carolina law the requirements of federal fair transfer pricing. The Directive's "excess of cost" standard means that the separate return of <u>every</u> corporation which follows federal guidelines for fair transfer pricing for intercompany transactions may, in the Department's discretion, be deemed not to reflect true earnings for North Carolina purposes.

An additional problem with the use of "cost" as a standard is that it is not clear and administrable. There is no generally accepted definition of "cost" for tax purposes in law or in fact. "Cost" is defined for certain limited purposes (*e.g.*, last in, first out accounting), but those definitions cannot be expanded for general use in determining whether a unitary group must file a combined return.

If the Department had undergone formal rule making, as it is required to do, all of these issues would have received citizen input through written and public comments and then would have been carefully scrutinized by the North Carolina Rules Review Commission.

3) There is no necessity for treating taxpayers differently. In issuing the Directive, the Department effectively acknowledges that it could have taken steps to conform taxpayer treatment under both statutes and thereby eliminate the two-regime problems:

- The Directive lists 25 factors the Department may consider to determine whether net income properly attributable to the State is disclosed on a return filed under the old statute. It lists the same 25 factors for determining whether a transaction has economic substance under the new statute.

- The entities the Directive says will be excluded from combination under the old statute are largely the same entities which the General Assembly has provided may not be combined under the new statute.

- The methodology and procedures for computing State net income under a forced combination are the same in the Directive under both the old and new statutes.

- The Directive states that the Department will examine the economic substance of some transactions under the old statute, as it is required to do under the new statute, acknowledging that economic substance of a transaction is also a proper subject of inquiry under the old statute. After all, if a business transaction has a legitimate purpose and if the transaction has economic substance as defined by the new statute, the Department should have no objection to that transaction under either the old statute or the new.

B) The Directive does not create the certainty that taxpayers need and the legislature intended.

As noted above, the Directive lists 25 factors the Department may consider to determine whether net income properly attributable to the State is disclosed on a return filed under the old statute. It lists the same 25 factors for determining whether a transaction has economic substance under the new statute. However, the Department states that the Department may also consider other factors that it does not include in its comprehensive list. Specifically, the Directive states, "That a factor is not included on this list does not mean that it will not be considered or is not relevant." This statement, included in the sections of the Directive dealing with both the old law as well as the new law, appears intended to give the Department unlimited discretion in its decisions regarding combination and leaves taxpayers without the certainty that the legislature intended in enacting the new law and that businesses need.

Moreover, the Department fundamentally misinterprets the economic substance test. Whether a transaction has economic substance is not an all-encompassing inquiry of various factors that may show that a transaction has been designed in a tax-efficient manner. The inquiry is much more straightforward: Does it have a valid business purpose and economic effects? If the answer to that two-part question is in the affirmative, the inquiry that the General Assembly has prescribed is at an end. The Directive, instead of acknowledging this basic feature of HB 619, designs its own vague test which lacks clarity or predictability and which could again be a tool for abuse.

II. The Directive erroneously interprets the legislation passed by the 2011 session of the General Assembly and by prior sessions of the General Assembly, significantly misstating the law.

A. <u>The Directive violates North Carolina law for years prior to 2012.</u>

1) **<u>Apportionment formula for combined group.</u>** Some of the Department's targets for combination have been members of unitary groups that include corporations required to apportion their income under the different apportionment formulae contained in G.S. 105-130.4. Without legislative authority, the Department has stated in the Directive that it will use the general three-factor formula with a double weighted sales factor for all of the group's combined income, unless more than 50% of the group's combined income subject to apportionment is generated from a business activity subject to special apportionment. This practice contravenes express legislative language which requires the use of different apportionment formulas for different kinds of businesses and does not acknowledge that some other apportionment approach might be fairer when entities with different formulae are combined.

The new legislation makes it clear that the Department must consider the different formulas in a forced combination for years beginning on or after January 1, 2012.

2) **<u>Joint and several liability</u>**. The Directive provides that every member of the combined group is jointly and severally liable for the combined group's tax liability. There is no statutory authority for imposing joint and several tax liability, and no authority to impose <u>any</u> tax liability on a corporation that has no nexus with this State.

B) <u>The Directive misstates and erroneously interprets new G.S. 105-130.5A.</u>

1) **<u>The Directive misstates the law in G.S. 105-130.5A as to consideration of the tax effects of a transaction, making the Directive unlawful.</u>**

a. Throughout its discussion of G.S. 105-130.5A, the Directive repeatedly misstates the clear language of the statute as to how tax effects of a transaction should be considered in determining economic substance. G.S. 105-130.5A(f) provides that an intercompany transaction has economic substance if it has one or more "reasonable business purposes other than the creation of State income tax benefits" and the transaction "has economic effects beyond the creation of State income tax benefits," (emphasis added), providing also that if State income tax benefits resulting from a transaction are consistent with legislative intent, those income tax benefits may be considered in determining both business purpose and economic substance.

In the face of that clear statutory language, the Directive states that the statute "mandates the use of a conjunctive two prong test to determine whether a transaction shall be found to have economic substance" and goes on to state that the first prong "requires that the transaction have one or more reasonable business purposes other than the creation of tax benefits" and the second prong "requires that the transaction have economic effects other than the creation of tax benefits."[1]

The Directive misstates the law as to both prongs since the law provides that it is state income tax benefits – not benefits derived from other portions of the tax code – that are subject to scrutiny.

Similar misstatements of the law are made elsewhere in the Directive.[2]

b. The Directive states that the taxpayer "bears the burden of proving that the transaction has economic substance and is absent the motive of tax avoidance."[3] The statute says no such thing and, in fact, recognizes the legitimacy of appropriate tax planning.

c. Further, the Directive attempts to engraft onto the statute a requirement relative to tax effects not set forth in the statute. The Directive states that "the asserted business purpose must be commensurate with the tax benefits claimed."[4] The General Assembly imposed no such requirement and it is difficult to understand how such a comparison would actually be made.

2) The Directive erroneously interprets the law beyond the authority of the Secretary.

a. Documentation of business purpose. The Directive states that, "The asserted business purpose must be supported by contemporaneous documentation."[5] The statute imposes no such requirement. It is unreasonable and incredibly burdensome to require businesses to document the business purpose for every intercompany transaction and then to require them to retain that documentation for many years. Corporate document retention policies frequently result in destruction of documents relative to challenged transactions long before audits commence, and corporations cannot be expected to generate written documentation of the

---

[1] Directive, Part Two, Section I.A (emphasis added).
[2] See Directive, Part Two, Section I.B, C, Section II.C, E 4.
[3] Directive, Part Two, Section II.A.2 (emphasis added).
[4] Directive, Part Two, Section II.B.4 (emphasis added).
[5] Directive, Part Two, Section II.B.5.

business purpose for every transaction. This rule, if allowed, would give the Department unreasonable power in an audit to pressure taxpayers by requesting business purpose documentation for virtually every aspect of the business. A more appropriate rule might acknowledge that more weight might be afforded contemporaneous documentation, but legitimate business planning may well exist where no documentation exists at the time of an audit.

b. **Proof of economic substance**. The Directive states, "The taxpayer must prove by objective evidence that the transaction affected the taxpayer's financial position in a positive and meaningful way apart from tax benefits."[6] There is no requirement in the new law that economic substance include a change to the taxpayer's financial situation. The statute clearly provides that business purpose and economic effects requirements of economic substance are met if there is a "material benefit" from the transaction. As an example, creation of a subsidiary to insulate a parent from liability is a straightforward example of a material benefit from a transaction where there might not be a change to the taxpayer's financial situation.

Similarly, a transaction may have material benefit even if it does not "substantially improve(s) the economic position of the taxpayer on a pre-tax basis."[7]

c. **Apportionment formula**. The Directive states that the apportionment formula for a combined group will be determined under the new law in the same manner as under the old law. Therefore, as explained above, the Department fails to take into account that different apportionment formulas may apply to different members of a combined group.[8] The Directive ignores the express language of G.S. 105-130.5A(h) requiring that the apportionment formula used in forced combination "fairly reflect(s) the apportionment formula in G.S. 105-130.4 applicable to the corporation and each member of the affiliated group included in the combined return."

d. **Creation of additional tests for "material business activity."** G.S. 105-130.5A states, "In determining whether to require a combined return, whether the transaction has economic effects beyond the creation of State income tax benefits may be satisfied by demonstrating material business activity of the entities involved in the transaction." The Directive provides that "along with material business activity, the principles, factors and rules in Section II (of the Directive) will also be considered in determining whether the transaction has economic effect beyond tax benefits." The Department, by this portion of the Directive, may recognize that there are additional ways to satisfy the economic effect test, beyond "material business activity," which would comport with the intent of the legislation. However, if the Department is stating that material business activity is not enough to satisfy that test and that other factors will be considered as well, it has attempted to engraft a requirement into the statute the General Assembly did not impose.

This is an ambiguity which rules review would have addressed.

---

[6] Directive, Part Two, Section C.2.
[7] Directive, Part Two, Section II.E.1.
[8] Directive, Part Two, Section II.V.D, incorporating Part One, Section V.F.

e. **Royalty reporting option.** The Department has apparently had concerns about alleged abuses of the royalty reporting option contained in GA 105-130.7A. It has responded to those alleged abuses and to the provisions of G.S. 105-130.5A, by stating in the Directive that, "[t]he Secretary can, however, adjust the amount of the payments if the transactions lack economic substance or are not at fair market value." The question of economic substance of intellectual property holding companies has been at issue since they became a popular tax planning device in the early 1990s, or earlier. The same companies have been held by some jurisdictions to have substance and by others not to have substance.[9] The North Carolina statute creating the royalty reporting option avoids the issue of economic substance and merely requires that the royalties be reported for taxation, either by the payor through an add back, or by the payee through filing a North Carolina tax return. An attempt by the Department to override the legislative intent of G.S. 105-130.7A, and to delve into issues of substance with intellectual property holding companies which have been reporting royalties to North Carolina under the options afforded by the law would be beyond its authority.

III. Publication of the Directive without undergoing formal rule making violates the North Carolina Administrative Procedures Act and the North Carolina Revenue Laws. The failure of the Department to undergo formal rule-making resulted in the erroneous interpretations of North Carolina law which are discussed below and results in the Directive being unenforceable.

Rules are defined under the Administrative Procedures Act as "any agency regulation, standard, or statement of general applicability that implements or interprets an enactment of the General Assembly ... or that describes the procedure or practice requirements of an agency." G.S. 150B-2(8a)

Excluded from the definition of "rule" are "nonbinding interpretative statements within the delegated authority of an agency that merely define, interpret, or explain the meaning of a statute or rule." G.S. 150B-2(8a) c. The Directive does not fall within this exclusion, as the Directive clearly states, "the interpretation in this Directive is a protection to the taxpayers affected by the interpretation and taxpayers are entitled to rely on this interpretation." Further, the Directive goes far beyond merely defining, interpreting or explaining the statute, as it includes lengthy guidelines for how the statute will be implemented and how taxpayers must compute the apportionment formula and prepare their tax returns.

The Department seeks to rely on G.S. 105-264 as statutory authority to bypass formal rule-making to issue this Directive. However, the Department is noticeably absent from G.S. 150B-1(c) which lists those administrative agencies and departments that have complete exemptions from the North Carolina Administrative Procedures Act. To the contrary, G.S. 150B-1(d)(4) is clear and unambiguous that the Department only has a specific and limited exemption from rule-making under the North Carolina Administrative Procedures Act – a limited exemption from the notice and hearing requirements as contained within Part 2 of Article 2A of

[9] *See Sherwin-Williams Co. v. Comm'r of Rev.*, 438 Mass. 71, 778 N.E.2d 504 (2002); *Sherwin-Williams Co. v. Tax Appeals Tribunal*, 2004 NY Slip Op 07737, 12 A.D.3d 112 (2004).

the Act. (The Department is instead subject to the notice and hearing requirements contained in G.S. 105-262.)

The 2011 session of the General Assembly, in adopting SB 781 which amended G.S. 150B, the Administrative Procedures Act, emphasized to agencies the importance of following the rule making process by providing, "An agency shall not seek to implement or enforce against any person a policy, guideline, or other non binding interpretive statement that meets the definition of a rule contained in G.S. 150B-2(8a) if the policy, guideline, or other nonbinding interpretive statement has not been adopted as a rule in accordance with this Article." G.S. 150B-18. In any event, as noted above, the Directive is not a nonbinding interpretative statement.

The 2010 General Assembly adopted an amendment to G.S. 105-130.6, <u>one of the statutes the Directive interprets</u>, by providing, "In order to provide clarity for taxpayers, the Secretary may adopt <u>rules in accordance with G.S. 105-262</u> that describe facts and circumstances under which the Secretary will require a corporation to file a consolidated or combined return." <u>G.S. 105-262 specifically requires that such rules be adopted in accordance with G.S. 150B, the Administrative Procedures Act.</u> The 2010 General Assembly also detailed the specific procedures to be followed for notice and hearing in connection with the adoption of such rules. (As noted above, although the Department is subject to G.S. chapter 150B's rule making requirements, it is exempt from the notice and hearing provisions of G.S. chapter 150B and those notice and hearing provisions are contained in G.S. 105-262(b).)

The Directive clearly is intended to "describe facts and circumstances under which the Secretary will require a corporation to file a ... combined return" (G.S. 105-130.6) and is clearly "an agency regulation, standard, or statement of general applicability that implements or interprets an enactment of the General Assembly...." G.S. 150B-2(8a). Despite the clear and explicit language of the General Assembly in 2010 and 2011 and a lack of an exemption from formal rulemaking under G.S. 150B-1(c), the Department ignored the legislative requirements with regard to rule making.

The Department apparently takes the position that it has the authority to issue the Directive without complying with the rule-making process because of the general authority given to the Secretary in G.S. 105-264(a) to interpret the tax laws. However, this general authority, which is an important function of the Secretary, must be construed with other statutory provisions governing that interpretive authority. Those statutes require compliance with the rule-making process set forth in the APA, with limited exceptions. *See* G.S. 150B-1(d)(4).

One of the purposes of that rule-making process is to prevent the errors and misinterpretations of the law like those contained in the Directive when an agency acts without proper rule-making review. Under review by the Rules Review Commission, statements in proposed rules which are without legislative authority or ambiguous are subject to review and objection, requiring the agency to address the objections. *See* G.S. 150B-21.9.

Had the Department complied with the APA and with the requirements of the General Assembly set out above, its Directive would have been more carefully drafted to comply with the reform legislation enacted in 2011 in HB 619 and with other provisions of the Revenue Laws, and its errors subject to review by an independent commission whose function is to assure that rules comport with legislation enacted by the General Assembly – not with an agency's notion of what the law should be.

In essence, if the Department intends to have the Directive be enforced with general applicability to all corporate taxpayers, the Department must undertake the process of formal rule making as set out in the North Carolina Administrative Procedures Act.