Overview of North Carolina's Corporate Income Tax

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Study of North Carolina's Tax Structure
Interim Joint House and Senate Finance Committees

Business Taxes in North Carolina

- Corporate Income Tax
- Franchise Tax
- Annual Reporting Fees
- Privilege and License Taxes
- Excise Tax on Certain Machinery & Equipment
- Sales Tax
- Property Tax

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Evolution of NC's Tax System

1777 — **Created Tax System**

2nd act of General Assembly

Evolution of NC's Tax System

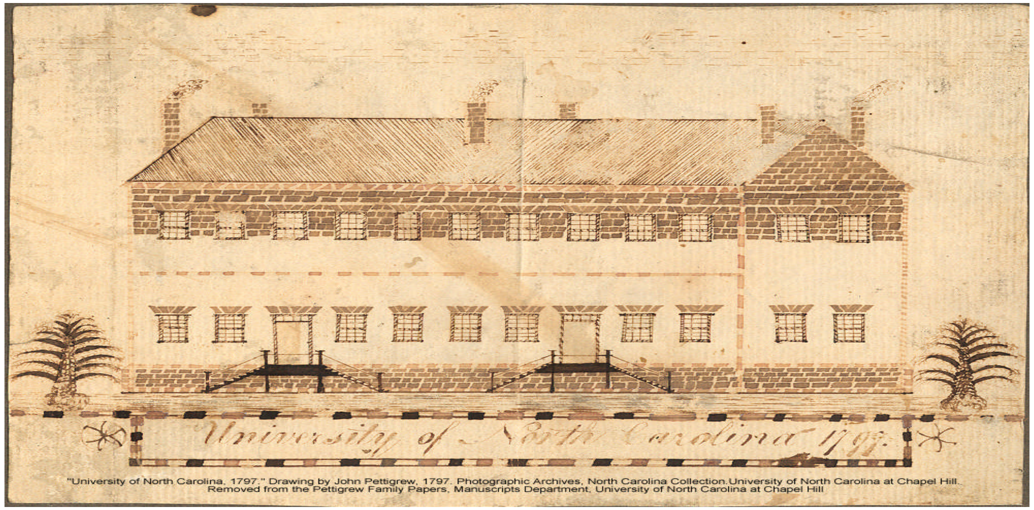
1782

License taxes first enacted

Evolution of NC's Tax System

1849

Corporations taxed on capital stock – forerunner of franchise tax



Free public schools in 1839

Evolution of NC's Tax System

Revenue Act of 1921

1921

No State tax on property

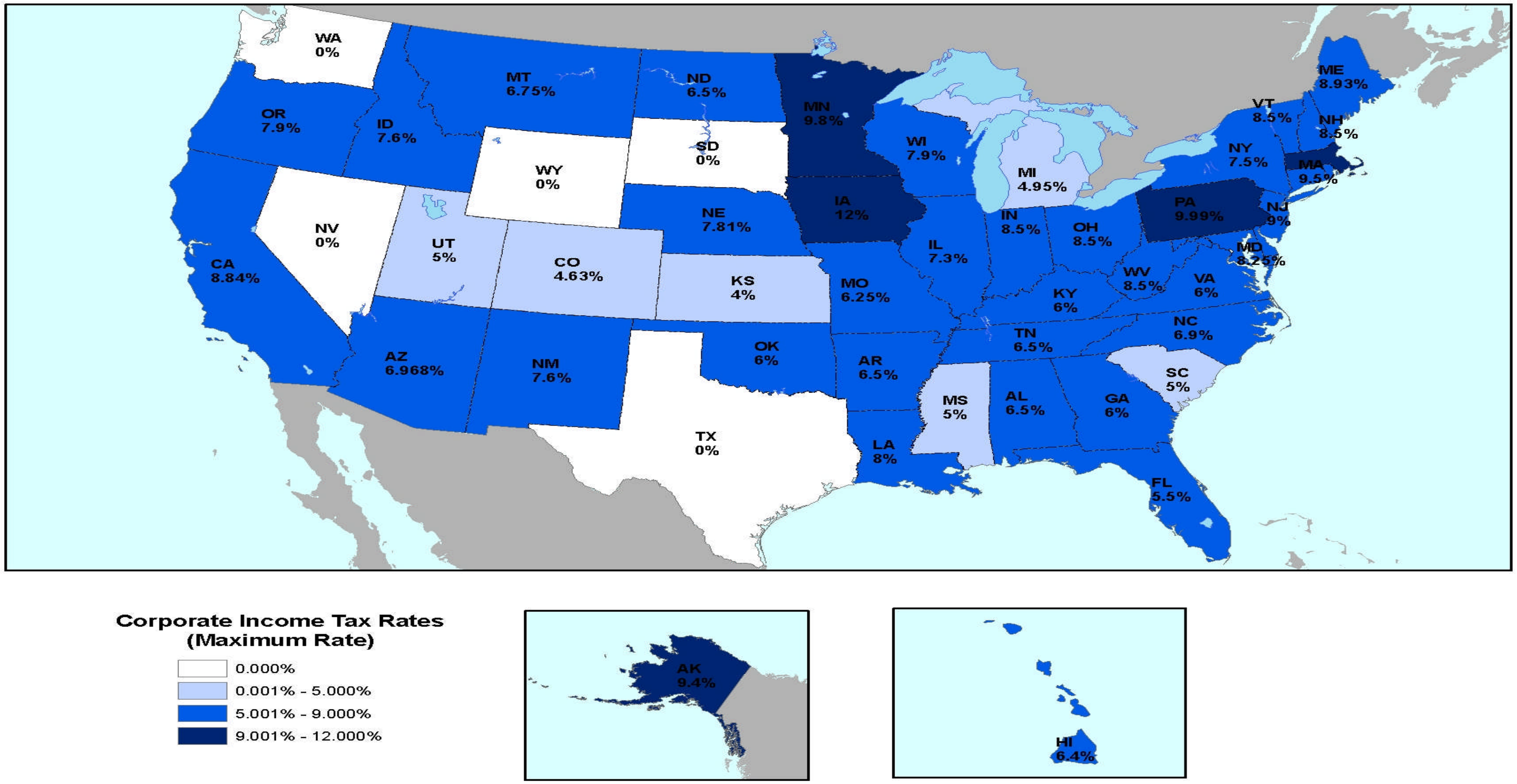
Two new taxes:

- **State administered PIT**
- **Corporate IT**

NC Corporate Income Tax Rates

- 1921: 3% of net income
- 1939: 6% of net income
- 1987: 7% of net income
  - Public School Building Fund
- 1991: 7.75% of net income, plus surtax
- 1996: phased down rate to 6.9%, effective after 1999
- 2009: 3% surtax for 2009 and 2010

Corporate Tax Rates



Corporate Income Tax Decline

- Since 1950s, the federal corporate income tax has been declining as a percentage of government revenues
- NC corporate income tax base has been following the same trend

Reasons for Decline of CIT

- Tax Policy Decisions
  - Federal tax policy decisions
  - NC tax policy decisions
  - State tax credits
- Tax Shifting Strategies
  - Made possible to a large degree by single entity reporting

Basic CIT Building Blocks

- Tax rate applied to net taxable income
  - All corporations chartered in NC
  - All corporations doing business in NC
- Tax credits applied

Taxable Income

- NC taxable income = Federal taxable income, as adjusted
  - Accelerated depreciation
- Key differences
  - Net operating loss v Net economic loss
  - Bonus depreciation
- State deduction adjustments

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Tax Policy Decisions that Reduce CIT Collections

State Tax Credits

- Dwelling units for handicapped
- Real property donations
- Conservation tillage equipment
- Gleaned crop
- Manufacturing cigarettes
- State ports
- Renewable energy
- Film production
- Small business health insurance
- WOTC
- Rehabilitation
- Low income housing
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Tax Policy Decisions that Reduce CIT Collections $164.5 million for FY 09-10

Apportionment Formula

- Multistate corporations apply NC apportionment formula to determine NC taxable income
- Apportionment formulas
  - Three factors: Sales, Property, and Payroll
  - Double-weighted sales (1988)
  - Single sales (2009 for a ‘qualified capital intensive corporation’)

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Tax Policy Decisions that Reduce CIT Collections

Business & Non-Business Income

Multi-state corporation required to:

- Allocate its non-business income to a state based on its connection with that state
- Apportion its business income between the states in which it conducts business based upon each state's apportionment formula

Business & Non-Business Income

- State law defines ‘business income’
- *Strategy:* Characterize income as non-business income
- Pre-2002, NC definition narrow
- 2002, NC changed its definition of business income to include all income that is apportionable under the US Constitution

Single Entity Reporting

State filing options

- Mandatory separate entity returns
- Elective consolidated returns
- Mandatory combined unitary returns
- Discretionary combined unitary returns
- A hybrid system
  - Require single entity reporting
  - Unless directed otherwise by Secretary of DOR

Single Entity Reporting

- NC requires a separate return
- Must determine State net income as if a separate return had been filed for federal tax purposes

- *Strategy:* Create legal structures to shift income from one state to another, lower tax, state
  - IHC
  - *Limited* case

Single Entity Reporting

Legislative efforts to address income shifting

- 2001: Royalty add-back
- 2002: Broad definition of business income
- 2005: Consideration of "throwout" rule
- 2006: Patent and copyright add-back
- 2007: Captive REITs

Single Entity Reporting

- "Forced combinations" by Secretary of DOR
  - Uncertainty as to when to combine
  - Uncertainty as to who is included in the combination
- *Walmart v. Hinton* upheld Secretary's authority to require combined reporting
- Millions collected through forced combinations – RECENT PROJECT

Tax Reform Options

- Mandatory combined reporting
  - Comprehensive way to nullify tax shifting strategies
  - Broadens the corporate tax base
  - Reduces uncertainty re: combinations
- Reduce tax credits and deductions
- Reduce corporate tax rate
- Equal weighted apportionment formula, with throw-out or throw-back rule