

**Summary of Remarks to the North Carolina  
Revenue Laws Study Committee**

**By**

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**Re:**

**Issues Involving the Enforcement of  
North Carolina's Forced Combination  
And  
Corporate Income Adjustment Powers  
Under  
General Statutes 105-130.6, 105-130.15. &  
105-130.16**

**September 5, 2006**

**Introduction** - Mike Hannah served as Assistant Secretary for Legal Services and the Hearings Officer at the NCDOR for nearly 8 years. He is currently employed by PricewaterhouseCoopers, LLP, where he assists corporate clients with NC and SC tax issues. It is hoped his varied work experience can provide some useful insight into the issues involved with enforcement of NC's forced combination and income distortion statutes.

1. The General Assembly has determined that NC is a "separate entity state" for purposes of corporate taxation. Corporations are usually taxed only on their NC operations, even if they also conduct business in other states. In fact, corporations are specifically precluded from filing tax returns that consolidate their NC and out of state operations without permission of the Secretary of Revenue, even if they do so for Federal purposes.
2. Three statutes were originally enacted in the 1930's to prevent corporations from artificially manipulating NC taxable income through the use of excessive payments to related out of state companies; the statutes have changed very little since enactment, while corporations have had to significantly change how they must be structured and conduct business to stay competitive in the evolving global economy.
3. In summary, the statutes permit the Secretary of Revenue to:
  - 1) eliminate intercompany transactions in excess of fair market value;
  - 2) combine the net incomes of in state and related out of state companies if he determines that NC taxable income is not being fairly reported because of improper transactions between related entities;
  - 3) recompute NC taxable income using any "reasonable methods of computation" to determine the "proper" state net income.
4. The Secretary of Revenue should have some reasonable powers to prevent the improper reduction of a corporation's NC taxable income through unnecessary or artificial intercompany transactions.

5. However, the Secretary has almost unlimited power to force combined returns and make income adjustments. Also, G.S. 105-130.6 requires that the final determination of NC taxable income "shall not be set aside unless shown to be plainly wrong." This nearly insurmountable standard of proof does not appear in any other NC tax statute and almost forces companies to file suit for relief, adding to taxpayer confusion and negatively impacting the state's business climate.
6. Modern corporations regularly utilize transactions between related special purpose entities for various and legitimate reasons such as inventory control, finance, management, protecting assets, etc., and to obtain economies of scale.
7. There has been a significant increase in the focus of NCDOR auditors on intercompany transactions and resulting assessments based on forced combination over the last three years, a factor highlighted by the Voluntary Compliance Program in 2005 and the Settlement Initiative in 2006.
8. I have the highest respect for my friend, Norris Tolson, his hard work and dedication to the NCDOR. I trust him to do what he believes is proper under the law. But, the NCDOR has declined to issue written interpretative guidelines, which makes following the law more difficult for taxpayers.
9. The forced combination/income distortion statutes are extremely broad, and there is no case law or written guidelines for applying them. The result is that corporations cannot determine whether their intercompany transactions are improper until they have already been assessed tax, penalties and interest after an audit. This is not equitable.
10. **At the very least consideration should be given to:**
  - 1) a reasonable limitation on the forced combination and income adjustment powers so that they apply only to improper, abusive or sham intercompany transactions,
  - 2) requiring written guidelines for applying the statutes,
  - 3) a more reasonable standard of proof that is similar to that used in other NC tax statutes,
  - 4) specific clarification of how the statutes are to be interpreted and operate mechanically, and
  - 5) restricting the use of penalties in such cases.