News & Trending
NEWS

BILL NELSON MAKES PRESENTATION TO REVENUE LAWS STUDY COMMITTEE

01.15.2009

Smith Anderson partner Bill Nelson testified before the Revenue Laws Study Committee at its December 15, 2008 meeting on the state's existing mandatory combined reporting rules for corporate taxpayers. Mr. Nelson's testimony was offered as part of the Committee's consideration of a proposal to move from a separate return state to a unitary combination state.

Mr. Nelson's experience includes tax planning for mergers, acquisitions and other business transactions and representing taxpayers before federal, state and local tax authorities in tax controversies. He is the co-author of CCH's Guidebook to North Carolina Taxes and is Adjunct Professor of law at the UNC Law School. He has also been active in a number of state tax legislation reform efforts.

The following are Mr. Nelson's comments:

"Thank you Mr. Chairman. My name is Bill Nelson. I practice tax law with the Smith Anderson firm here in Raleigh. Let me say at the outset that, while I have experience with these issues, I am not involved in any way with the combined return cases that are currently in litigation and that I am not currently representing any clients in combination cases before the Department. Therefore, what I hope to offer is the perspective of corporate taxpayers and their advisers generally rather than the perspective of any particular taxpayer. Let me also say that I am not here to address the policy issue of whether NC changes from a separate return state to a mandatory combined reporting state but only the state of our existing laws on combined reporting.

While taxpayers recognize the need for the DOR to have tools to combat abuses, this need must be balanced against the honest taxpayer's need for certainty and for some reasonable restraints on administrative discretion.

The Multistate Tax commission, which as you know is an organization of taxing authorities rather than of taxpayers, has said that any combined reporting structure "must" answer three main questions:

- When is combined reporting required
- Who is required to be included in the combined report
- How is the combination to be accomplished

[Huddleston & Sicilian, History and Considerations for Combined Reporting: Will States Adopt A Model Combined Reporting Statute?]

The MTC's own draft combination statute takes eight pages to address these issues while leaving many technical issues to be addressed by state rulemaking.

Section 130.6, at less than one printed page, fails to address these issues with any precision, with the result that the Secretary has almost unbridled discretion over how these issues are resolved. Let me add here that while the Secretary has stated that three other statutes also provide authority for combined reporting, these other statutes never mention the word combined reporting or consolidated returns, so there is a dispute on this point.

When is combination required?

The statute authorizes forced combination when a separate return does not "disclose the true earnings of the corporation on its business carried on in this State" but does not define "true earnings".

In the context of a separate return state, taxpayers can reasonably argue that true earnings are those that would be shown on a separate return if the taxpayer's dealings with related parties were entered into at arm's-length, so that combination is just an alternative means of eliminating excess intercompany payments.

The Secretary argues that its discretion is not limited by the arm's-length standard. In the Wal-Mart litigation the Secretary has suggested that he can require combination whenever a transaction lacks economic substance. This position is not grounded in the statutory language and hardly gives taxpayers much guidance. Moreover, anecdotal evidence suggests that the DOR has not always justified its demands for combined reports on a purported lack of economic substance. Moreover, the Secretary has not indicated that lack of economic substance is the sole predicate for requiring combination.

The worry among taxpayers is that if the Secretary prevails in decoupling forced combination from the arm's-length standard, that is, if he can require combination even where a taxpayer's returns fully disclose all related party transactions and all those transactions are conducted at arm's-length, then he will have essentially converted the state from a separate return state to a mandatory combination state without legislative action with the added wrinkle that unlike true mandatory combination states, taxpayers will not be entitled to file combined returns unless directed to do so by the DOR, thus giving the state the choice of demanding the return that produces the most revenue.

Who is required to be included?

The statute limits combination to corporations that are the parent, subsidiary or affiliate of the taxpayer and provides definitions of these terms – although those definitions are exceedingly broad.

It fails, however, to address some important questions, such as whether foreign corporations can be combined and whether a water's edge election is available.

More importantly, there is confusion over whether all domestic affiliates must be included in the return. The statute says that the Secretary can require a combined return "of the entire operations of the parent corporation and of its subsidiaries and affiliates" suggesting that all such subsidiaries and affiliates must be included – subject to constitutional limitations.

However, the DOR has publicly claimed the right to pick and choose the affiliates to be included. [The DOR's 2006 presentation to Revenue Laws stated that a combined return did not have to include all group members and Kay Hobart's 1994 presentation to SEATA (p. 13) makes this point clearly].

How is combination to be accomplished?

There are many technical issues that arise in preparing combined returns, such as how deductions and credits are to be applied. Needless to say, the NC statute does not address any of these issues.

The DOR has not Offered Administrative Guidance.

Subject to limitations imposed by the Constitution and by principles of administrative law, the DOR could have filled some of the gaps in the statutory scheme, but it has not done so.

There are no administrative rules, directives or TAMs on forced combination. There is a very meager technical bulletin which does little more than repeat the statutory language. DOR representatives have made statements in the past that indicate that the lack of guidance represents a strategic choice on the part of the Department to maximize its power to combat unforeseen abuses.

While the Department's position is understandable, it keeps honest taxpayers in the dark about the Secretary's intentions.

There is also a dearth of any other interpretive guidance on forced combinations.

There is no legislative history of any substance available to elucidate the relevant statutes. Legislative history is, in any event, a very uncertain guide to meaning, and the Wal-Mart litigants plausibly follow all the legislative history to opposite conclusions.

There is some dicta in a handful of the Secretary's hearing decisions, but these decisions do not provide no rules of general application and were in any event decided on the nexus issues rather than forced combination.

There are no reported decisions construing the scope of the combined reported statutes. Although we will eventually have one or more reported decisions, judicial decisions do not usually advance the cause of clarity, are limited to the facts at issue and are not likely to answer all the questions.

Lack of Taxpayer Protections.

The imprecise statutory language and the poverty of interpretive guidance has served to stack the decks against the taxpayers by maximizing the scope of the discretionary powers the Secretary has claimed for itself.

The taxpayer's ability to challenge overreaching by the Department is severely limited by an odd provision in the statute that provides that the Secretary's determinations on forced combinations will be upheld unless "plainly wrong."

Other assessments can be overcome by a preponderance of the evidence, and the plainly wrong standard does not, to my knowledge, appear in any other tax statute.

This standard has been described by one knowledgeable commentator [Hannah, North Carolina's Next State and Local Tax Frontier: Forced Combination, Journal of Multistate Taxation and Incentives, January 2006] as the "guilty until proven innocent" standard and by another commentator [Miller, Consolidated and Combined Reporting in a Single Entity State: A North Carolina perspective (July 1994)] as equivalent to the "beyond a reasonable doubt" standard required to support a criminal conviction. It makes the meager opportunities afforded to challenge the Secretary's determinations largely illusory and makes even litigation of doubtful assistance.

Given the taxpayer's uncertainty about the circumstances in which the Secretary can require combination and the legal impediments to challenging the Secretary's determinations, taxpayers should at least not be subject to penalties when combination is required.

And yet the Secretary has asserted the right to impose significant penalties where the difference between the tax due on a separate return and that shown to be due on a combined return results in a large understatement.

The breadth of the discretion the vagueness of the statute has allowed the Secretary to claim together with the absence of any real taxpayer remedies is perhaps the best argument that the statute should be given a narrow interpretation since the legislature might be presumed not to put taxpayers in such an untenable position.

Perhaps better yet, in my opinion, it provides justification for a legislative overhaul of the statute to balance the Department's legitimate enforcement needs with taxpayer safeguards and certainty."

PROFESSIONALS

William W. Nelson

PRACTICE AREAS

Mergers and Acquisitions

Tax