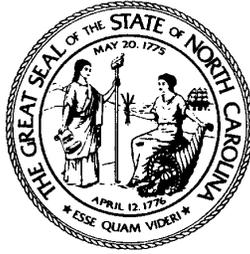

North Carolina Department of Revenue



DIRECTIVE

Subject: Secretary's Authority to
Require a Corporation to File a Combined Return

Tax: Corporate Income

Law: G.S. 105-130.6, G.S. 105-130.15, and G.S. 105-130.16

Issued By: Income Tax Division, Corporate Section

Date: April 17, 2012

Number: CD-12-01

This Directive is published by the Secretary of Revenue pursuant to G.S. 105-264. The interpretation in this Directive is a protection to the taxpayers affected by the interpretation and taxpayers are entitled to rely on this interpretation.

This Directive explains the Department's current practice with respect to the Secretary's authority under G.S. 105-130.6, G.S. 105-130.15, G.S. 105-130.16 and other law to require a corporation to file a combined income tax return with its parent, subsidiaries, and affiliates for tax years beginning before January 1, 2012.

Under current law, G.S. 105-130.6 authorizes the Secretary to eliminate amounts paid by a corporation to an affiliated corporation in excess of fair compensation. G.S. 105-130.6 also authorizes the Secretary to require a corporation doing business in North Carolina to file a combined corporate income tax return with some or all of its affiliated corporations if the separate entity income tax return filed by the corporation does not disclose the true earnings of the corporation on its business carried on in this State. The Secretary is authorized by G.S. 105-130.15(a) to require a corporation to use a different method of accounting if the method of accounting used by the corporation does not clearly reflect the corporation's net income. G.S. 105-130.16(b) also authorizes the Secretary, when a corporation conducts its trade or business in a manner that either directly or indirectly distorts its true net income and the net income properly attributable to the State, to correct the distortion. The application of G.S. 105-130.15 and G.S. 105-130.16 may result in a combination as in G.S. 105-130.6 or the disallowance or reduction of deductions for amounts paid by a corporation to an affiliated corporation.

The Secretary is also authorized to make adjustments to a taxpayer's income under other law. For example, because North Carolina has adopted federal taxable income as the starting point in determining a corporation's State net income, the Secretary is authorized to adjust a corporation's income under judicially created doctrines.

I. Conditions for a Combined Return

The determination that a combined income tax return is required will be based on the facts and circumstances in each case using the conditions set forth in this Directive. A combined income tax return may be required where all of the following conditions are met:

A. Common Ownership or Control

The first condition that must be met for a group of corporations to be required to file a combined income tax return is common ownership or control of more than 50% of the voting stock. To be included in the combined group, a corporation must be a parent, subsidiary or affiliate of a corporation or a group of corporations. A corporation is considered a subsidiary of another corporation when, directly or indirectly, it is subject to control by the other corporation by stock ownership, interlocking directors, or by any other means whatsoever exercised by the same or associated financial interest, whether the control is direct or through one or more subsidiary, affiliated, or controlled corporations. A corporation is considered an affiliate of another corporation when both are directly or indirectly controlled by the same parent corporation or by the same or associated financial interests by stock ownership, interlocking directors, or by any other means whatsoever, whether the control is direct or through one or more subsidiary, affiliated, or controlled corporations.

A combined income tax return is required regardless of whether the parent or controlling corporation or interests or its subsidiaries or affiliates, other than the taxpayer, are or are not doing business in this State.

B. Unitary Business

The second condition that must be met for a group of corporations to be required to file a combined income tax return is that the corporations are part of a unitary business.

A unitary business means one or more related business organizations where there is a unity of ownership, operation and use. It can also exist where there is interdependence in their functions. A determination of whether a corporation is part of a unitary business with another corporation is determined based on the facts and circumstances of each case.

C. Net Income Properly Attributable to the State Not Disclosed

The third condition that must be met for a group of corporations to be required to file a combined income tax return is that reporting on a separate entity basis does not disclose the net income of the corporation properly attributable to the State.

Intercompany transactions in excess of cost may indicate that net income attributable to the State is not disclosed, regardless of any transfer pricing study in support of the charges.

Intercompany transactions that shift an income producing asset from one entity to another may indicate that net income is not disclosed. The Department will evaluate these transactions based on the economic substance of the intercompany transaction.

Notwithstanding G.S. 105-130.7A and G.S. 105-130.12, a combined income tax return may be required when the net income attributable to this State is not properly reflected on the corporations' separate entity returns.

II. Factors the Department May Consider in Determining Whether Net Income Properly Attributable to the State is Disclosed.

The determination whether a report by a corporation properly discloses the net income attributable to this State is a fact intensive inquiry and dependent on each taxpayer's specific facts and circumstances. Some of the factors that the Secretary will consider in analyzing intercompany transactions to determine whether net income properly attributable to the State is disclosed are listed below and are in no order of significance. That a factor is not included on this list does not mean that it will not be considered or is not relevant. Taxpayers seeking further guidance may request a private letter ruling from the Department pursuant to G.S. 105-264.

- What were the specific reasons for the transaction?
- Was the transaction a reasonable means to accomplish the asserted purposes?
- What benefits did the entity or entities expect to obtain from the transaction?
- What effect did the transaction have on the taxpayer's profits?
- Did any reasonable or realistic potential for profit from the transaction exist?
- What was the objective economic impact of the transaction, apart from tax savings?
- What effect did the transaction have on the taxpayer's North Carolina tax liability?
- What effect did the transaction have on the taxpayer's tax liability in other states?
- What effect did the transaction have on the taxpayer's federal tax liability?
- Is the method of determining the amount of payment an industry practice?
- Did the business operations of the parties change after the transaction?

North Carolina Department of Revenue

- Were specific assets transferred between or among related entities?
- Did the business operations related to those assets change after the transfer?
- Did the entity transferring assets retain control over the assets?
- What were the tax consequences of the transfer of assets?
- Who were the motivating parties for the transaction?
- Who were the primary parties involved in actions that created the transaction?
- Who presented the transaction to the taxpayer?
- Did the presentation documents discuss profit potential or just tax benefits?
- Did any parties conduct a cost-benefit analysis or other studies related to the transaction?
- Did the taxpayer obtain any non-tax benefits as a result of the transaction?
- What parties drafted the agreements relating to the transaction?
- What parties negotiated the agreements?
- Who dictated the terms of the agreements?
- Did the intercompany transaction result in a circular cash flow?

III. Entities Included in a Combined Return

A combined income tax return will include only those entities in the unitary business whose intercompany transactions cause net income of the business carried on in this State not to be properly disclosed on a separate entity basis.

IV. Entities Excluded from a Combined Return

The following entities will be excluded from a combined return:

- A. A corporation not required to file a federal income tax return.
- B. An insurance company that is subject to tax under Article 8B of Chapter 105 of the General Statutes of North Carolina.
- C. A corporation exempt from taxation under Internal Revenue Code section 501.
- D. An S Corporation.
- E. A partnership, limited liability company, or other entity not taxed as a corporation.

V. Methodology

The following procedures shall be used to calculate the combined group's income attributable to this State:

North Carolina Department of Revenue

- A. The starting point is the federal taxable income of the pro forma 1120 for each corporation. The 1120s should represent federal taxable income “as if” each corporation were not part of a consolidated federal 1120.
- B. Combine the pro forma 1120s of the corporations to be included in the combined group; this results in a combination of each corporation's line items in determining combined income.
- C. Eliminate the intercompany transactions between members of the combined group in arriving at combined federal taxable income.
- D. Make North Carolina modifications (additions & subtractions) as provided in G.S. 105-130.5 to determine combined income subject to apportionment.
- E. Include in the apportionment factors the property, payroll and sales of all corporations included in the combined group as provided in G.S. 105-130.4. All sales into North Carolina by entities within the combined group are included in the sales factor numerator. Where an intercompany transaction has occurred and been eliminated in the calculation of combined income, this amount is also eliminated from the numerator and denominator of the applicable factor.
- F. Only one apportionment formula is to be calculated for the combined group. The standard three factor formula shall be used unless more than 50% of the group's combined income subject to apportionment is generated from a business activity subject to special apportionment under subsections (m) through (sl) of G.S. 105-130.4. In that case, the formula applicable to that industry is used to apportion the income of the entire group. Apply the combined apportionment factor to the combined apportionable income to determine income apportioned to this State.
- G. Add any nonapportionable income allocated to North Carolina to the income apportioned to this State to determine total income subject to North Carolina tax.
- H. The combined group's income subject to tax may be reduced by net economic losses sustained by a corporation that becomes a member of the group, but not fully used by that corporation prior to becoming a member of the combined group, subject to the provisions of G.S. 105-130.8. Net economic losses brought by a corporation into the group remain with that corporation and, to the extent not used by the group during the years the corporation is part of the group, may be claimed by the corporation in the tax years after the corporation ceases to be a part of the group. The tax years that the corporation is part of the combined group count toward the 15 year carryforward period authorized in G.S. 105-130.8. A net economic loss sustained by the group in a combined return year is allocated among the members of the group that reported losses on their pro forma 1120s, after elimination of intercompany transactions between members of the combined group. The amount allocated to each member is determined by dividing that member's loss (after elimination of intercompany transactions) by the total losses (after elimination of intercompany transactions) of all members of the combined group in that tax year. To the extent not used by the group during the years the corporation is part of the group, the group's net economic losses

allocated to a corporation that is a member of the group may be claimed by the corporation in the tax years after the corporation ceases to be a part of the group. Net economic losses are considered used in order beginning with the earliest tax year. If more than one corporation brought net economic losses from the same tax year into the combined group and a portion of the losses from that year is used, the amount of used net economic losses is prorated among the members bringing losses from that year based on the percentage of each member's losses to the total losses carried forward from that year.

- I. The combined group's income tax may be reduced by tax credits earned by a member of the combined group, but not fully used by that entity prior to becoming a member of the combined group, subject to the provisions of the specific credits. Because the eligibility for a tax credit is determined at the separate entity level, any unused installment or carryforward of a tax credit earned by a member of the combined group remains with that entity if that entity is no longer a member of the combined group or the group is no longer required to file a combined return. This is applicable whether the credit was earned by the entity before becoming a member of the combined group or while a member of the combined group. For franchise tax purposes, the tax credits may only be used by the entity generating the credit.

VI. Procedures

A. Income Tax

A corporation reporting the combined net income of a group shall file Form CD-405, the North Carolina C Corporation Tax Return, and fill in the "combined return" circle located on page 1 of the return. The combined income tax return and all required schedules shall be filed by the principal reporting member. The principal reporting member is a member of the combined group that acts in the group's name in all matters relating to the income tax liability for the combined group, and is the entity responsible for preparing the corporate income tax return and making corporate income tax payments for the combined group. The combined income tax return replaces the separate entity corporate income tax returns filed by the members of the group that are doing business in this State. Every member of the combined group is jointly and severally liable for the combined group's tax liability under this Part, including any interest and penalties.

A corporation filing a combined Form CD-405 shall include the following schedules:

1. A computation of the North Carolina taxable income of each corporation in the combined return that would have been reported if the member had filed a North Carolina income tax return on a separate company basis.

North Carolina Department of Revenue

2. A schedule detailing all intercompany eliminations made by and between the members of the unitary group.
3. A schedule of all North Carolina income tax estimated payments made by each member of the group.
4. A schedule reflecting the computation of the combined apportionment factor as indicated above at V.F. Taxpayers should not use Schedule O of the CD-405.
5. A schedule of eligible net economic losses and the use of same by member entities and the combined group.
6. A schedule of eligible tax credits and the use of same by member entities and the combined group.

B. Franchise Tax

Each corporation that is doing business in this State pursuant to G.S. 105-114(b)(3) shall file a separate North Carolina franchise tax return and pay any franchise tax due. Any corporation that is included in a combined income tax return but that is not doing business in this State pursuant to G.S. 105-114(b)(3) is not subject to North Carolina franchise tax.

1. The principal member shall file its franchise tax return on the combined group's CD-405.
2. All other members' separate returns shall include \$0 on the "Net Taxable Income" and "NC Net Income Tax" lines on the CD-405 and include a statement with the return that indicates that (i) its income is included in the combined income tax return filed by the principal reporting member and (ii) identifies the name and Federal Employer Identification Number of the principal reporting member.
3. If the corporation filing a franchise tax return is a multistate taxpayer, then it shall calculate its apportionment factor to be used in calculating its capital stock base using its separate entity property, payroll and sales before intercompany eliminations. Schedule O of the CD-405 must reflect the entity's apportionment factor for franchise tax purposes.

C. Tax Credits

Any member of the combined group that has activities that qualify for a North Carolina income tax credit shall complete all forms required by the Secretary to determine and support the amount of the credit on a separate company basis. These forms shall be included with the combined return in each year the qualifying member becomes eligible to claim a credit or an installment of a credit, even if the group's income tax liability for that year is not sufficient for the combined group to benefit from the income tax credit.

North Carolina Department of Revenue

Combined groups eligible to claim income tax credits shall complete Form CD-425, Corporate Tax Credit Summary, on a combined basis and file it with the group's income tax return. If a member of the combined group is eligible to claim an income tax credit limited by statute to 50% of tax, the combined group shall also complete Form NC-478, Summary of Tax Credits Limited to 50% of Tax.

D. Submitting Returns

Mail:

Corporate Combined Return
NCDOR
P.O. Box 871
Raleigh, NC 27602-0871

Hand Delivery:

Corporate Combined Return
NCDOR
501 N. Wilmington Street
Raleigh, NC 27604-8001

To ensure proper handling, the principal member shall submit the combined income tax return including a payment voucher for the corporate income tax of the combined group. All separate entity franchise tax returns shall be submitted with the combined income tax return. A separate franchise payment voucher shall be completed for each company required to file a return.