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North Carolina Legislation Affecting Taxation of Business

- 6/27/2009

On June 27, 2009, Tax Executives Institute filed the following comments with the Republican and Democratic leaders of the House and Senate Finance Committees of the North Carolina General Assembly concerning North Carolina Senate Bill 202, relating to a bill that would expand the State's franchise tax to pass-through entities and implement a "throwback rule" for taxpayers selling tangible products from locations in North Carolina to States in which they have no income tax obligations. TEI's comments were prepared under the aegis of its State and Local Tax Committee, whose chair is Cathleen Stevens of Brunswick Corporation. Contributing substantially to the development of TEI's comments was Jamie S. Fenwick of Time Warner Cable. Daniel B. De Jong, TEI Tax Counsel, serves as legal staff liaison to the committee.

June 27, 2009

On behalf of Tax Executives Institute ("TEI" or "the Institute"), I urge the amendment of Senate Bill 202, which is currently being considered by the North Carolina legislature. While the bill broadly applies to all areas of North Carolina's budget, our letter focuses solely on certain sections of the bill that would affect the taxation of businesses. Specifically, we comment on those provisions that would expand the State's franchise tax to all entities with limited liability (Section 27B.2), and force corporations to include sales to states in which they are not subject to tax in their sales factors (also referred to as a "throwback" rule) (Section 27B.3). The amendments we propose in this letter fall into two categories: Technical corrections to the proposed statutory language, and substantive changes designed to avoid the enactment of ill-conceived tax policies.

Senate Bill 202 also includes provisions that would mandate combined reporting for unitary groups of corporations doing business in North Carolina. The absence of any comments on the combined reporting sections of Senate Bill 202 in this letter should not be construed as tacit support for or disapproval of those provisions. Historically, TEI has not taken a position for or against combined reporting, and we provide no opinion on that issue here.

Background

Tax Executives Institute was founded in 1944 to serve the professional needs of business tax professionals. Today, the organization has 54 chapters in North America, Europe, and Asia, including one in North Carolina. Our 7,000 members represent 3,200 of the largest companies in the world, many of which are either resident or do business in North Carolina. As the preeminent international association of business tax professionals, TEI has a significant interest in promoting sound tax policy, as well as in the fair and efficient administration of the tax laws, at all levels of government.

Franchise Tax on Business Entities

Under current law, the franchise tax applies only to corporations and limited liability companies that elect to be treated as corporations for federal income tax purposes. Section 27B.2 of the Senate Bill 202 ("the Bill") would amend Article 3 of Chapter 105 of the North Carolina General Statutes to expand the state franchise tax to all entities providing limited liability to their members or partners regardless of their treatment for federal and North Carolina income tax purposes. This represents a significant shift in North Carolina tax policy, which currently treats legal entities as

taxable or not based on their federal tax classification for both income and franchise tax purposes.

In addition to the large number of pass-through entities that would be swept into North Carolina's taxing net, the Bill would result in multiple layers of taxation on the same franchise values in tiered pass-through entity structures. The Bill also leaves many unanswered questions that will surely confound both taxpayers and the Department of Revenue. TEI suggests the following corrections to the Bill in order to make the legislation administrable and fair.

A. Multiple Layers of Taxation

Proposed G.S. § 105-122(b2), added by section 27B.2.(d) of the Bill, provides that noncorporate business entities must compute their franchise tax base by combining the capital accounts of their owners computed in accordance with generally accepted accounting principles. As a result, the value of any interests held by one business entity in another business entity (*e.g.*, a parent's interest in a subsidiary entity) will be included in the calculation of franchise tax base. The absence of any mechanism to subtract from a parent entity's tax base the value of its holdings in subsidiaries would result in the parent and the subsidiary entity both paying tax on the value attributed to the subsidiary. Where structures are more complex, the application of the franchise tax to noncorporate entities would cause the value of a subsidiary entity at the bottom of a structure to be taxed again and again (*i.e.*, creating a pyramiding tax system without any possibility for relief).

Creating a taxing scheme in which the same value is taxed on multiple occasions is bad tax policy. To avoid such a result, other jurisdictions that impose taxes on noncorporate business entities have included a mechanism to reduce or eliminate double taxation. In the District of Columbia, for example, unincorporated businesses must pay a tax based on their net income;1 the computation of net income, however, includes a subtraction for any amounts that have already been subjected to the tax.2 New York City also imposes an income-based tax on unincorporated entities doing business in the city,3 but rather than providing an income exclusion, the city accords taxpayers owning interests in entities subject to New York City's unincorporated business tax a credit for tax paid by lower-tier entities.4 Even Tennessee, which also imposes a franchise tax on certain pass-through entities, gives affiliated taxpayers the ability to file a consolidated franchise tax return within which all intercompany holdings are eliminated.5 To avoid multiple layers of taxation here, language should be included in the Bill providing either an exclusion from the calculation of an unincorporated entity's net worth, a credit for franchise taxes paid by a lower tier unincorporated business entity, or the ability for affiliated entities to file on a consolidated basis.

The treatment of related-party debt also affects the computation of a noncorporate business entity's franchise tax base and presents a risk for double taxation. Proposed G.S. § 105-122(b2), added by section 27B.2.(d) of the Bill, provides that "[a] business entity must add to its net worth all indebtedness owed to it by a related person" (*i.e.*, the creditor entity must add back the affiliated indebtedness). Corporations, on the other hand, must add back debt owed to affiliated corporations in the calculation of the tax base (*i.e.*, the corporate debtor must add back the affiliated indebtedness). To reduce the potential for double taxation, the statute provides corporations with an exception when the creditor corporation is also subject to the franchise tax. In that situation, the language of the Bill states that "the creditor corporation is allowed to deduct from the total of its capital, surplus, and undivided profits the amount of any debt owed to it by a parent, subsidiary, or affiliated corporation to the extent that the debt has been included in the tax base of the parent, subsidiary, or affiliated debtor corporation reporting for taxation under the provision to this section." No such relief provision exists, however, to remedy the potential for double taxation created by applying the related party debt rule to noncorporate business entities.

In the case of a corporation, the calculation of the tax base includes a subtraction for "[d]efinite and accrued legal liabilities." Where debt is owed by a corporation to an affiliated noncorporate business entity, the language in the Bill would require the creditor noncorporate business entity to add this debt to its tax base. There is balance to that approach since the subtraction from the corporate debtor's tax base equals the addition to the tax base of the noncorporate business entity. Where one noncorporate business entity is indebted to another affiliated noncorporate business entity, however, no such balance exists. The calculation of the tax base for a noncorporate business entity does not permit a subtraction for "definite and accrued legal liabilities." Thus, when one noncorporate business entity is indebted to another, the debtor does not subtract the debt from its tax base but the creditor still must increase its tax base by the amount of the loan. To better align the treatment of corporate taxpayers with the treatment of noncorporate business entities and avoid additional multiple taxation of values, the Bill should be amended to require the addition of related party debt to the tax base of a noncorporate business entity only when the related debtor is a corporation.

B. Nexus and Apportionment Confusion

Although noncorporate business entities would be subject to an entity-level tax under the Bill, it is not clear whether the nexus attributes of one entity would flow through to its owners for franchise tax purposes. In the corporate income tax context, "[a] corporation which is a member of a partnership or joint venture doing business in North Carolina is subject to North Carolina income tax,"[6] whereas the mere holding of stock in a corporation doing business in the State does not create nexus. That approach is premised on the income and loss from noncorporate business entities flowing through to their owners for income tax purposes. If noncorporate business entities must now pay a franchise tax, the tax policy rationale for also flowing through a noncorporate business entity's nexus attributes disappears.

The language of the Bill provides no clarification on the critical issue of nexus and its application in the context of entities owning interests in noncorporate business entities subject to the franchise tax. Rather, section 27B.2.(d) of the Bill would amend G.S. § 105-122(a) to impose the franchise tax on all business entities "doing business" in North Carolina, but the Bill retains the current definition of "doing business" as "[e]ach and every act, power, or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State." Absent clarification, taxpayers and the Department of Revenue will likely disagree with whether the nexus attributes of a noncorporate business entity affect the nexus analysis of its members or partners for franchise tax purposes (*i.e.*, by constituting "doing business"). In light of the separate entity treatment envisioned by the Bill, the nexus attributes of noncorporate business entities should not flow through to its owners. This result can be accomplished by adding a sentence to the end of the "doing business" definition stating: "The ownership of an interest in a noncorporate business entity doing business in the State does not, by itself, cause such a corporation or noncorporate business entity to be doing business in the State."

This same issue exists in the apportionment computations required of noncorporate business entities. Under section 27B.2(d) of the Bill, entities not subject to the corporate income tax "must apportion [their] net worth by using the fraction it would be required to apply in apportioning its income if it were subject to" the corporate income tax. The Department of Revenue's regulations state that a corporate partner "shall include its proportionate share of the partnership's property, payrolls and sales" when calculating its apportionment percentage for income tax purposes.[7] If, as suggested, the nexus attributes of a noncorporate business entity do not flow through to its owners and the value of lower-tier entities is excluded from the franchise tax base, then the Bill should be revised to clarify that the apportionment attributes also do not flow through. Failing to address this issue would cause the taxation of net worth that has no relation to a business's activities in North Carolina.

C. Alternative Tax Base

The language in the Bill modifying the alternative tax base for franchise tax purposes appears to include an error. Under current law, corporations calculate their apportioned tax base (*i.e*., prior to applying the tax rate) by using the highest of three amounts: (1) total capital stock, surplus and undivided profits apportioned to North Carolina; (2) 55% of the appraised value of all real and tangible personal property in the State; and (3) the total actual investment in tangible property in the State. The amount determined to be the greatest is then subject to tax at a rate of $1.50 per $1,000. Under section 27B.2.(d) of the Bill (modifying G.S. § 105-122(d)), taxpayers' actual tax liability (rather than their apportioned tax base) will not be less than the greater of 55% of the appraised value of all real and tangible personal property in the state or the actual investment in tangible property in the State. Essentially, the Bill makes the highest of the alternative tax bases the tax instead of merely the base for the tax. Presumably this result is unintended and should be changed. Specifically, TEI recommends that the Bill be revised to read:

> "Alternative Tax Base. The apportioned capital base determined under subsection (c1) of this section ~~The tax imposed by this section~~ shall not be less than fifty-five percent (55%) of the appraised value as determined for ad valorem taxation of all the real and tangible personal property in this State of each business entity nor less than its total actual investment in tangible in this State."

The "Throwback" Provision

Section 27B.3.(a) would amend G.S. § 105-130.4(l)(2) to require that corporate taxpayers include in the sales factor numerator all sales of tangible personal property to customers located in States where the taxpayer is not taxable (this rule is also referred to as a "throwback" rule). States use apportionment as a method for determining the amount of a taxpayer's income that is properly attributable to their State. For purposes of the sales factor, States generally include in the numerator only those sales of tangible personal property delivered to locations within their State. Implementing a throwback rule does not advance the goal of determining the amount of taxable income attributable to a taxpayer's activities in the taxing State because it effectively includes extraterritorial values in the tax base. Instead, throwback rules increase or decrease the amount of taxable income attributed to States based on the taxpayer's activities in *other* States.

The arbitrariness of this approach calls into question the constitutionality of the throwback provision. To satisfy the constitutional requirement that state taxes be "fairly apportioned," a State's apportionment methodology must be fair and reflect a "rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436-37 (1980). The throwback concept fails this test since the taxability of a taxpayer in one State bears no relation to its level of business activity in another State. The intent of throwback provisions (such as that proposed in the Bill) is for States to simply impose their taxes on income that other States have chosen not to tax or that they are constitutionally prohibited from taxing.

The use of a throwback rule would also discourage investment in North Carolina. When faced with the decision of where to locate a new manufacturing plant or other facility, a taxpayer may decide to build in Georgia, Tennessee, or another State where no throwback rule exists. TEI strongly recommends that the throwback provision in the Bill be eliminated.

Conclusion

TEI appreciates this opportunity to present its views on Senate Bill 202. If you have any questions about the Institute's views or desire additional information regarding the comments contained in this letter, please do not hesitate to contact Cathleen Stevens, Chair of TEI's State and Local Tax Committee, at 847.735.4672 (cathleen.stevens@brunswick.com) or Daniel B. De Jong of TEI's legal staff at 202.638.5601 (ddejong@tei.org).

Tax Executives Institute, Inc.

Vincent Alicandri
International President

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1 D.C. Code § 47-1808.01, *et seq*.

2 D.C. Code § 47-1803.02(a)(2)(D).

3 NYC Administrative Code § 11-503(a).

4 NYC Administrative Code § 11-503(j).

5 Tenn. Code Ann. § 67-4-2103(g).

6 N.C. Admin. Code § 5C.1701.

7 N.C. Admin. Code § 5C.1702.

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