

**IMPORTANT NOTICE REGARDING THE SECRETARY'S AUTHORITY TO ADJUST
THE NET INCOME OF A CORPORATION OR TO REQUIRE A CORPORATION TO
FILE A COMBINED RETURN**

On June 30, 2011, Governor Perdue signed into law Session Law 2011-390 (House Bill 619) enacted by the General Assembly. This law repeals the Secretary's existing statutory authority in G.S. 105-130.6, 105-130.15 and 105-130.16 to adjust a corporation's net income or require a combined return effective January 1, 2012. The repealed statutory provisions have been replaced with a new statute, G.S. 105-130.5A, which authorizes the Secretary to adjust the net income of a corporation or to require a corporation to file a combined return. The new statute is effective for tax years beginning on or after January 1, 2012. The new law does not affect the Secretary's authority under other law to adjust a taxpayer's income. This notice briefly summarizes the Secretary's authority and explains what authority applies to which time periods. The Department is in the process of reviewing House Bill 619 and will provide further guidance in the near future.

Secretary's Authority

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. Effective January 1, 2012, section 1 of S.L. 2011-390 repeals G.S. 105-130.6, section 3 rewrites G.S. 105-130.15(a) and section 4 deletes G.S. 105-130.16(b).

Section 2 of S.L. 2011-390 enacts new G.S. 105-130.5A. Subsection (b) of the new statute authorizes the Secretary, upon finding as a fact that a corporation's intercompany transactions lack economic substance or are not at fair market value, to redetermine the State net income of the corporation properly attributable to its business carried on in the State by (i) adding back, eliminating, or otherwise adjusting intercompany transactions or, if such adjustments are not adequate to redetermine State net income, (ii) requiring the corporation to file a combined return. Subsection (f) of the bill defines economic substance for purposes of the new statute. Subsection (g) provides that, in determining whether transactions between members of an affiliated group of entities are not at fair market value, the Secretary shall apply the standards contained in the regulations adopted under section 482 of the Internal Revenue Code. Section 2 is effective for assessments proposed for taxable years beginning on or after January 1, 2012.

The Secretary is also authorized to make adjustments to a taxpayer's income under other law. The new law does not affect this authority. 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, including the economic substance doctrine, recently codified as Code section 7701(o).

Application of the Various Authorities

Assessments Proposed Before January 1, 2012

Because the new law does not repeal the existing specific statutory authority until January 1, 2012, it does not affect corporate income tax assessments proposed before January 1, 2012. G.S. 105-130.6, G.S. 105-130.15(a) and G.S. 105-130.16(b) therefore remain applicable to any assessment proposed before the effective date of the repeal, in addition to other authority.

Assessments Proposed On or After January 1, 2012 for Tax Years Beginning Before January 1, 2012

G.S. 105-130.6, G.S. 105-130.15(a) and G.S. 105-130.16(b) are repealed effective January 1, 2012 and are therefore not applicable to assessments proposed on or after January 1, 2012. New G.S. 105-130.5A is not effective for tax years beginning prior to January 1, 2012. The new law does not affect the Secretary's authority under other law to adjust a taxpayer's income. 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, including the economic substance doctrine, recently codified as Code section 7701(o). In addition, the Secretary is authorized to adjust income under applicable authority in the Internal Revenue Code, including adjusting deductions from intercompany transactions if the amounts paid are in excess of fair market value under section 482 of the Code. The Secretary will continue to rely on this other authority.

Assessments Proposed for Tax Years Beginning on or After January 1, 2012

New G.S. 105-130.5A is effective for tax years beginning on or after January 1, 2012 and applies to assessments proposed for tax years beginning on or after this date. Under the new law, the Secretary may redetermine the net income of a corporation if the Secretary finds that the company's transactions lack economic substance or are not at fair market value. The Secretary may redetermine net income by adding back, eliminating or otherwise adjusting intercompany transactions. The Secretary may also require a combined return, but only if other adjustments to intercompany transactions are not adequate to redetermine net income. The Secretary's authority to adjust a corporation's income under other law remains applicable and the Secretary will continue to rely on this authority in addition to new G.S. 105-130.5A.