New Law Requires Department of Revenue to Adopt "Rules" on Combined Reporting

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This summer, the North Carolina General Assembly revised our state's "forced combination" corporate income tax statutes for the third time in three years. This year's revision, in Session Law 2012-43 (S.B. 824), requires the Department of Revenue to adopt a formal rule interpreting the substantive provisions of the new combination statute that was enacted in the 2011 legislative session. Like the changes enacted in 2010 and 2011, the new statute appears motivated by a desire to force the Department to be more transparent in its decision-making and to give taxpayers clearer and more concrete guidance on when they can expect to be compelled to report their income on a combined basis. Whether the new statute will in fact lead to greater clarity in this murky and controversial area remains uncertain. At minimum, however, the formal rulemaking procedures mandated by the new statute will give businesses affected by North Carolina's combined reporting laws the opportunity to participate in the process of determining how and when the Department can wield its combination power.

COMBINED REPORTING CONTROVERSY AND THE LEGISLATIVE RESPONSE

Controversy over the Department's authority to require affiliated corporations to report their income on a combined basis is not new. The Department's reliance on forced combination as a means of combating alleged tax shelters garnered increased attention as a result of two widely publicized recent lawsuits, Wal-Mart Stores East, Inc. v. Hinton and Delhaize America, Inc. v. Lay, in which the taxpayers challenged the Department's authority to require combined reporting. Although the Department ultimately had its assessments in both cases affirmed by the Court of Appeals, the facts unearthed in these cases (and particularly in the Delhaize case) generated criticism of the Department's audit practices in combination cases and triggered a series of revisions to the forced combination statutes, including this summer's bill ordering the Department to engage in a formal rulemaking process. Much of the controversy concerning forced combination in North Carolina stemmed from accusations that the Department was intentionally concealing the standards it applied in determining whether to require taxpayers to file a combined report. See Amy Hamilton,

"Transparency in North Carolina: Portrait of a State in Flux," State Tax Notes, July 16, 2012, at 149; Jennifer Carr, "North Carolina Plays Hide the Ball with Forced Combination Guidance," State Tax Notes, Feb. 23, 2009, at 603. This controversy triggered the legislature's ongoing tinkering with the substantive and procedural provisions of North Carolina's combined reporting laws.

Before this year's legislation required the Department to adopt a formal rule outlining its approach to forced combination, in the 2010 legislative session, the General Assembly invited the Department to "adopt rules . . . that describe facts and circumstances under which the Secretary will require a corporation to file a consolidated or combined return." See G.S. 105-130.6(d) (repealed by N.C. Sess. Law 2011-390). The 2010 bill also provided an expedited procedure, set forth in G.S. 105-262(b), for notice, comment, and a public hearing on any rule proposed under G.S. 105-130.6. (These expedited procedures closely resembled the procedure for adoption of a temporary rule under G.S. 150B-21.1(a3), which are made applicable to rules adopted under G.S. 105-130.5A in the 2012 bill, as discussed below.)

Before the Department actually submitted a proposed rule for administrative review, however, in the 2011 session the legislature took the more drastic step of repealing Section 105-130.6, the combination statute that had remained essentially unchanged for the preceding 70 years, and enacting a new combination statute, Section 105-130.5A, which adopted an "economic substance" standard for determining when the Department has the authority to order combined reporting.

THE DEPARTMENT'S ATTEMPT AT ADMINISTRATIVE GUIDANCE ON FORCED COMBINATIONS

The new combination statute did not require the Department to adopt rules or otherwise publish additional guidance to implement its provisions. Shortly after the enactment of Section 105-130.5A, however, the Department issued a directive (Directive CD-11-01) outlining its approach to combined reporting under the new statute and under the now-repealed Section 105-130.6. Notably, this directive was the Department's first meaningful public explanation of its approach to combination under Section 105-130.6 in the history of that statute. (The Department's biennial Technical Bulletins prior to CD-11-01 had simply regurgitated the language of Section 105-130.6, without further explication.) In April of this year, the Department revised the 2011 directive and divided its interpretations into two separate directives – one addressing its approach to combination under Section 105-130.6, which remains applicable for tax years prior to 2012, and one addressing its approach under the new statute, which applies to 2012 and subsequent tax years. See Directives CD-12-01 and CD-12-02.

In light of its historical reluctance to provide specific guidance concerning forced combinations, and the absence of a specific statutory provision requiring the Department to provide written guidelines, the mere fact that the Department offered these directives at its own behest could be seen as a positive step for taxpayers and legislators concerned about the lack of transparency in the Department's approach to combined reporting. For many commentators and some legislators, though, the approach taken by the Department in these directives did not provide the clarity taxpayers need to determine whether they will be required to report their income on a combined basis or resolve concerns about the Department's alleged arbitrary approach to combinations in the past. See Hamilton, supra; see also Jasper L. Cummings, Jr., "Voluntary and 'Forced' Combinations in North Carolina," Tax Assessments, January 2012, at 1.

The directives provided a list of 25 "factors that the Department may consider in determining whether a transaction has economic substance." Directive CD-12-02, § II.D. This list of factors is expressly non-exclusive, however, and the Department reserved the ability in the directive to consider other factors. One could also easily find fault with the contents of the Department's list. For instance, some of the factors suggest the Department views any transaction that results in tax savings as lacking in economic substance, and others suggest fairly routine aspects of commercial transactions, such as "circular flow of cash," can justify a forced combination. See Cummings, supra, at 6. While North Carolina law (G.S. 105-264) provides that taxpayers are "entitled to rely" on the contents of a directive, the open-ended, facts and circumstances approach taken by the Department in its directives make it difficult to imagine how a taxpayer could cite to the directives to defend a transaction or reporting position under audit. The vagaries of the standards

outlined in the directives are made even more problematic because the directive places the burden of proof on the taxpayer to show that its transactions have economic substance. If economic substance is whatever the Department says it is, how can any taxpayer meet this burden of proof? Imperfect as it is, however, the list does at least provide insight into the Department's approach to combination, which previously was not available.

Perhaps more important than the substance of the directives was the way in which the directives were issued. Directives are essentially unilateral actions, publications issued by the Department without an opportunity for taxpayer comment, public hearing, or administrative review. Given the heated controversy over this issue in recent years, and the fairly weighty decisions made in the Department's directives, the Department's approach of interpreting the new combination statute in the form of a directive simply did not satisfy the General Assembly. This summer, the General Assembly responded with Session Law 2012-43.

PROCEDURES MANDATED BY THE NEW STATUTE

Session Law 2012-43 adds a new tax administration statute, Section 105-262.1, which prohibits the Department from employing any of the tools given to it under Section 105-130.5A "until a rule adopted by the Secretary in accordance with this section becomes effective." The new statute expressly prohibits the Department from interpreting Section 105-130.5A "in the form of a bulletin or directive." Interestingly, the new statute provides no further instruction to the Department on the contents of the rule it must adopt before ordering another combined report or otherwise adjusting a taxpayer's income under Section 105-130.5A. In theory, then, the Department could begin ordering combined reporting again after adopting a rule interpreting one of the narrower and less controversial provisions of Section 105-130.5A, such as the notice requirements of Section 105-103.5A(a).

Fortunately, the Department does not appear to be planning to take this end-around approach to the new statute. At this stage, at least, the Department intends to use the 2012 directive as a starting point for its proposed rule. Interview with Tom Dixon, Assistant Secretary of Revenue (Sept. 6, 2012); see also Hamilton, supra. Although the Department's rule will not be subject to full-scale notice, comment, and review under the North Carolina Administrative Procedure Act ("NCAPA"), it will be subject to the abbreviated procedures applicable to "temporary" rules under the NCAPA. See G.S. 105-262.1(a), (d); 150B-21.1(a3).

In adopting the rule required by Section 105-262.1, the Department must comply with the following notice and comment procedures:

At least 30 business days prior to adopting the rule, the Department must submit the rule and a notice of public hearing to the Codifier of Rules (an officer appointed by the Chief Administrative Law Judge of the N.C. Office of Administrative Hearings). The Codifier of Rules must then post the proposed rule and the notice of hearing on the Internet within five business days. G.S. 150B-21.1(a3)(1).

At least 30 business days prior to adopting the rule, the Department must also notify persons on the mailing list of persons who have requested notice of rulemaking from the Department. G.S. 150B-21.1(a3)(2). The NCAPA requires the Department to compile and maintain this list. G.S. 150B-21.2(d). Persons interested in receiving notice of the Department's proposed rulemaking should contact Janice Davidson, at 919.733.4629, or janice.davidson@dornc.com.

The Department must accept written comments on the proposed rule for at least 15 business days prior to adopting the rule. G.S. 150B-21.1(a3)(3).

The Department must hold at least one public hearing on the proposed rule, which must occur at least five days after the proposed rule has been published. G.S. 150B-21.1(a3)(4).

Section 105-262.1 also requires the Department to prepare a "fiscal note" for the proposed new rule, unless the proposed rule is submitted to the Codifier of Rules before December 31, 2012. See N.C. Sess. Law 2012-43, § 4. If the Department submits its proposed rule before the end of the year, it will be entitled to rely on a "fiscal memo" on the economic impact of Section 105-130.5A that was prepared by the Fiscal Research Division of the General Assembly in 2011 in lieu of

preparing its own fiscal note. Id. If the Department misses this end-of-year deadline, it will be required to prepare a fiscal note that meets all the content requirements of the NCAPA, including (among other things) a description and estimate of the expenditures taxpayers will incur in order to comply with the rule, and a description of at least two alternatives to the proposed rule that were considered and rejected, and the reasons for rejecting those alternatives. See G.S. 150B-21.4(b2). Given the likely burdens associated with preparing a fiscal note, the Department has a strong incentive to submit its proposed rule before the end of this year, and Department officials have indicated that is their intent. Interview with Tom Dixon, Assistant Secretary of Revenue (Sept. 6, 2012).

Taxpayers concerned about the content of the Department's prior directives on Section 105-130.5A should be pleased that they will have the ability to seek administrative review of the Department's proposed rule before it takes effect. Any person may object to the Department's proposed rule at any time prior to the adoption of the rule or by 5:00 p.m. on the third business day after receiving electronic notice that the rule has been adopted. G.S. 105-262.1(d). If the Department receives an objection to its rule, the rule must be submitted to the Rules Review Commission ("RRC") of the Office of Administrative Hearings for review. G.S. 105-262.1(e). The RRC is not permitted to consider "questions relating to the quality or efficacy of the rule," but it is permitted to consider whether the rule is "clear and unambiguous." G.S. 105-262.1(e). The RRC may also consider whether the rule is within the authority delegated to the Department by the General Assembly and whether it is "reasonably necessary to implement or interpret" a federal or state statute. Id.

If the RRC finds that the Department's rule does not meet these standards – for instance, if the rule is not "clear and unambiguous" – then the RRC must send the Department a written objection to the rule. Interestingly, the Department then has the option either to change the rule in response to the RRC's objection or to inform the RRC that the Department "has decided not to change the rule." G.S. 105-262.1(g). If the Department decides not to change the rule, the rule will not be published in the North Carolina Administrative Code and will therefore not take effect. See G.S. 105-262.1(k). However, in that event, the Department can request that the RRC "return" the rule, and can then file a declaratory judgment action in Wake County Superior Court. Although the statute does not expressly state as much, presumably the purpose of such a declaratory judgment action would be to obtain an order determining that the rule adopted by the Department satisfies the requirements of G.S. 105-262.1 and should therefore be approved by the RRC and published in the Administrative Code.

WHAT'S NEXT FOR COMBINED REPORTING IN NORTH CAROLINA?

Taxpayers and businesses affected or potentially affected by combined reporting in North Carolina have reason to applaud the enactment of G.S. 105-262.1. For the first time, the legislature has forced the Department not only to publicize its approach to forced combinations but also to accept comments from taxpayers and subject its guidelines to review by an independent administrative agency. Ultimately the statute may not produce the type of guidance some taxpayers and business groups desire, but taxpayers will at least have the opportunity to have their concerns about the Department's approach heard in a forum (the Rules Review Commission) that may be better equipped than the General Assembly to address taxpayers' concerns. Moreover, until those concerns are resolved, the Department is prohibited from ordering further combinations.

None of this is to suggest that the forced combination wars in North Carolina will end any time soon. The Department has indicated it intends to submit a proposed rule that closely resembles the directives that failed to satisfy many in the business community. As a result, the battles over the Department's combination practices may have simply been shifted from the legislature and the courts to the Rules Review Commission. After that, depending on how the business community and the Rules Review Commission respond to the Department's proposed rule, the Department may once again find itself defending its approach to forced combinations in the courts.