SUBCHAPTER 05F – SECRETARY'S AUTHORITY TO ADJUST NET INCOME OR TO REQUIRE A COMBINED RETURN

SECTION .0100 - GENERAL

17 NCAC 05F .0101 SCOPE

The rules in this Subchapter apply to the Secretary's authority under G.S. 105-130.5A to adjust net income or to require a combined return for taxable years beginning on or after January 1, 2012.

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

17 NCAC 05F .0102 DEFINITIONS

As used in G.S. 105-130.5A and this Subchapter, the following definitions shall apply:

(1) "Centralized cash management" means a process by which an affiliated group of businesses makes all or most cash management decisions from one location, such as a headquarters or designated subsidiary, that results in individual affiliates having little autonomy in making decisions concerning how cash is managed.

(2) "Economic position" means the status of a taxpayer's assets, liabilities, and equity (whether those items are actual, contingent, or potential) and their interrelationship to one another.

(3) "Material benefit" means an improvement in the economic position of the taxpayer on a pre-tax basis.

(4) "Material business activity" means an activity that is both:
  (a) An integral part of the unitary group's business; and
  (b) Performed on a regular and continuous basis.

(5) "Principal member" means 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.

(6) "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.

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

SECTION .0200 – ECONOMIC SUBSTANCE

17 NCAC 05F .0201 ECONOMIC SUBSTANCE TEST BURDEN OF PROOF

The taxpayer has the burden of proving that a transaction meets both prongs of the economic substance test as specified in G.S. 105-130.5A(g).

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

17 NCAC 05F .0202 REASONABLE BUSINESS PURPOSES

(a) In proving that a transaction, or series of transactions of which the transaction is a part, has one or more reasonable business purposes other than the creation of State income tax benefits, the taxpayer must show:

(1) The business purpose asserted was valid and realistic;

(2) The transaction was a reasonable and realistic means to accomplish the asserted business purpose;

(3) Evidence exists that shows the taxpayer took steps to achieve the asserted business purpose; and
(4) The value of the non-State income tax benefits reasonably anticipated by the taxpayer from the transaction exceeds the additional cost associated with the transaction.

(b) Generally, reasonable business purpose is supported by contemporaneous documentation. Though not conclusive, the absence of contemporaneous documentation weakens the contention that the asserted business purpose is valid.

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

17 NCAC 05F .0203 ECONOMIC EFFECTS

(a) In proving that a transaction, or series of transactions of which the transaction is a part, has economic effects beyond the creation of State income tax benefits, the taxpayer must show by objective evidence that a reasonable likelihood of material benefit, other than State income tax benefits, from the transaction existed at the time the transaction was initiated and there was a material benefit to the transaction apart from State income tax benefits.

(b) In analyzing whether a transaction has an economic effect, the Secretary shall analyze the economic effect on the taxpayer and on the aggregate economic effect on the parties to the transaction.

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

17 NCAC 05F .0204 ECONOMIC SUBSTANCE DOCTRINE

The Secretary shall rely on general principles of the common law economic substance doctrine as established under federal and state case law in applying each prong of the two pronged test under G.S. 105-130.5A(g), except where case law conflicts with the statute. General principles of the economic substance doctrine include the following:

(1) Economic substance is a prerequisite to any provision allowing deductions;
(2) A taxpayer has the burden of proving that a transaction has both purpose and substance;
(3) A taxpayer has the burden of showing that the form of the transaction accurately reflects its substance and that deductions claimed are permissible;
(4) The economic substance of a transaction shall be determined based on documentation and data rather than the subjective opinions of the taxpayer; and
(5) The transactions, not the entities, shall be examined for economic substance.

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

17 NCAC 05F .0205 ECONOMIC SUBSTANCE FACTORS

Determining whether or not a transaction has economic substance is a fact-intensive inquiry that is dependent upon the facts and circumstances of each transaction made by a taxpayer. The Secretary shall consider or analyze all the facts and circumstances including the following:

(1) The reasons for the transaction;
(2) Whether the transaction was a reasonable means to accomplish the asserted purposes;
(3) Expectations of benefits obtained from the transactions;
(4) The effects the transaction had on the taxpayer's profits;
(5) The existence of a reasonable or realistic potential for profit from making the transaction;
(6) The objective economic impact of the transaction other than State income tax savings;
(7) The transaction's effect on the taxpayer's State income tax liability;
(8) The transaction's effect on the taxpayer's tax liability in other states;
(9) The transaction's effect on the taxpayer's federal tax liability;
(10) Whether the method of determining the amount of payment is an industry practice;

(11) The change in the business operations of the parties, if any, after the transaction;
(12) Whether assets were transferred between or among related parties;
(13) Whether the business operations related to specific assets changed after any transfer of those assets;
(14) Whether the entity transferring assets retained control over the assets;
(15) The tax consequences of the transfer of assets;
(16) The party or parties who created or developed the ideas which led to the transaction;
(17) The party or parties who presented the ideas concerning the transaction to the taxpayer;
(18) Whether the contemporaneous documentation explaining the transaction to the taxpayer discussed profit potential in addition to tax benefits;
(19) The party or parties that drafted the agreements relating to the transaction;
(20) The party or parties that negotiated the agreements relating to the transaction;
(21) The party or parties that dictated the terms of the agreements relating to the transaction;
(22) Cost-benefit analyses or other studies conducted related to the transaction;
(23) Non-tax benefits obtained by the taxpayer as a result of the transaction; and
(24) Whether the intercompany transaction resulted in a circular cash flow.

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

17 NCAC 05F .0206 WHEN STATE INCOME TAX BENEFITS ARE CONSIDERED

(a) State income tax benefits resulting from a transaction are considered by the Secretary in determining whether a transaction has reasonable business purposes and economic substance when the State income tax benefits are consistent with legislative intent, such as when the transaction is made in accordance with laws enacted by the General Assembly to encourage engagement in certain types of activities through tax deductions or tax credits.

(b) When a transaction that generates targeted tax incentives is, in form and substance, consistent with the State income tax benefits designed by the General Assembly, the State income tax benefits shall be considered by the Secretary in determining whether the transaction has reasonable business purposes and economic substance.

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

17 NCAC 05F .0207 CENTRALIZED CASH MANAGEMENT

Although the existence of a centralized cash management system among members of an affiliated group is not conclusive evidence that a transaction lacks economic substance, the Secretary shall analyze the transactions for reasonable business purposes and economic effects. If the cash management transaction, or series of transactions of which the transaction is a part, results in the creation of unreasonably excessive interest expense when compared to industry practice, shifting of assets, or the reclassification of income as nonapportionable or nonallocable, the transaction may be deemed to lack economic substance.

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

SECTION .0300 – FAIR MARKET VALUE

17 NCAC 05F .0301 DETERMINATION OF FAIR MARKET VALUE

(a) For purposes of determining whether or not transactions between members of an affiliated group were made at fair market value under the standards contained in the regulations adopted under section 482 of the Internal Revenue Code pursuant to G.S. 105-130.5A(h), the Secretary shall consider all facts and circumstances relative to the transactions, including any transfer pricing studies provided by the taxpayer.

(b) In determining whether or not transactions were made at fair market value, the Secretary will also apply any federal or state case law developed under section 482 of the Internal Revenue Code and its regulations.
(c) The fact that a taxpayer has a transfer pricing study will not in and of itself be sufficient to establish that a transaction was made at fair market value.

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

SECTION .0400 - ADJUSTMENTS

17 NCAC 05F .0401 ADJUSTMENTS TO STATE NET INCOME

Adjustments the Secretary may make to intercompany transactions that are found to lack economic substance or not to be at fair market value include the following:

(1) Disallowing deductions in whole or in part;
(2) Attributing income to related corporations;
(3) Disregarding transactions; and
(4) Reclassifying income as apportionable or allocable.

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

SECTION .0500 – COMBINED RETURNS

17 NCAC 05F .0501 METHODOLOGY WHEN COMBINED RETURN REQUIRED OR PERMITTED

When the Secretary requires or allows a corporate taxpayer to submit a combined return, the following methodology applies:

(1) The starting point is the federal taxable income of the pro forma 1120 for each corporation. The 1120s shall represent federal taxable income "as if" each corporation were not part of a consolidated federal 1120;
(2) The taxpayer shall 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.
(3) The taxpayer shall eliminate the intercompany transactions between members of the combined group in arriving at combined federal taxable income.
(4) The taxpayer shall make North Carolina modifications (additions and subtractions) as provided in G.S. 105-130.5 to determine combined income subject to apportionment.
(5) The taxpayer shall 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 shall be included in the sales factor numerator. Where an intercompany transaction has occurred and been eliminated in the calculation of combined income, this amount shall also be eliminated from the numerator and denominator of the applicable factor.
(6) Only one apportionment factor is to be calculated by the taxpayer for the combined group. Unless otherwise provided in this section, the standard three factor formula, which uses the apportionment factors of property, payroll, and sales, shall be used. If more than 50 percent of the group's combined income subject to apportionment is generated from a business activity subject to special apportionment under subsections (m) through (s1) of G.S. 105-130.4, then that apportionment formula shall be used for the entire group. If the taxpayer believes the statutory apportionment method that otherwise applies to the combined group subjects a greater portion of the group's income to tax than is attributable to its business in this State, the taxpayer may propose, and the Secretary shall consider, an alternative method of apportionment. The taxpayer shall apply the

combined apportionment factor to the combined apportionable income to determine income apportioned to this State.

(7) The taxpayer shall add any nonapportionable income allocated to North Carolina to the income apportioned to this State to determine total income subject to North Carolina tax.

(8) 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 shall be 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 shall be 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 shall be considered used in order beginning with 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 shall be 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.

(9) 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 unless the group also files a combined return for franchise tax purposes.

History Note: *Authority G.S. 105-130.4; 105-130.5; 105-130.5A; 105-130.8; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

17 NCAC 05F .0502 PROCEDURES FOR FILING A COMBINED INCOME TAX RETURN

(a) The principal member shall file Form CD-405, The North Carolina C Corporation Tax Return, and all required schedules. The combined tax return replaces the separate entity corporate income tax returns filed by the members of the group that are doing business in this State.

(b) The principal member 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;

(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 required in 17 NCAC 05F .0501(6). Taxpayers shall 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; and

(6) A schedule of eligible tax credits and the use of same by member entities and the combined group.

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

17 NCAC 05F .0503 COMBINED RETURN TAX CREDITS

(a) Any member of the combined group that has activities that qualify for a North Carolina income tax credit shall provide all required information to determine and support the amount of the credit on a separate company basis. This information 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 tax year is not sufficient for the combined group to benefit from the income tax credit.

(b) 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 percent of tax, the combined group shall also complete Form NC-478, Summary of Tax Credits Limited to 50 Percent of Tax.

History Note: *Authority G.S. 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.

SECTION .0600 – FRANCHISE TAX RETURN

17 NCAC 05F .0601 PROCEDURES FOR FILING A FRANCHISE TAX RETURN

(a) The provisions of this Rule apply unless the Secretary authorizes a combined group to file a combined franchise tax return under G.S. 105-122. 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.

(b) The principal member shall file its franchise tax return on the combined group's CD-405.

(c) All other members' separate returns shall include zero dollars ($0) on the "Net Taxable Income" and "NC Net Income Tax" lines on the CD-405 and include a statement with the return that:

(1) Indicates its income is included in the combined income tax return filed by the principal member; and

(2) Identifies the name and Federal Employer Identification Number of the principal member.

(d) If the corporation filing a franchise tax return is a multistate taxpayer, then it shall calculate an 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.

History Note: *Authority G.S. 105-114(b)(3); 105-122; 105-130.5A; 105-262.1;*
Eff. January 31, 2013;
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. August 19, 2017.