



NCACPAC Conference North Carolina corporate tax deep dive

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Agenda



01

North Carolina income tax deep dive issues

02

North Carolina franchise tax deep dive issues

North Carolina corporate income tax



Allocation and apportionment



- Allocation refers to non-apportionable (non-business in some states) income that is specifically allocated to a particular state in which the taxpayer is doing business.
- Apportionment refers to apportionable (business in some states) income that is divided, or apportioned, among the states in which the taxpayer is doing business.

Allocation and apportionment (continued)



- Apportionable income – how does North Carolina define the term? As of 2017...
 - All income that is apportionable under the US Constitution, including income that arises from either of the following:
 - a. Transactions and activities in the regular course of the taxpayer's trade or business.
 - b. Tangible and intangible property if the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer's trade or business.”
- - Non-apportionable income means all income other than apportionable income.
- 2017 clarification of prior definition (2002): All income that is apportionable under the United States Constitution

Allocation and apportionment (continued)



- Polaroid Corp. V. Secretary of Revenue of the State of North Carolina (1998):
 - Proceeds from a patent infringement lawsuit -- the North Carolina Supreme Court established that the definition of “business income” encompassed not only a transactional test, but also a functional test to determine whether income from the disposition of property is subject to apportionment. The court determined that “under the functional test, income is classified as business income if it arises from the acquisition, management, and/or disposition of an asset that was used by the taxpayer in the regular course of business.” Furthermore, “when determining whether a source of income constitutes business income under the functional test, the extraordinary nature or infrequency of the event is irrelevant.”
- Lenox, Inc. v. N.C. Dep’t of Revenue (2001)
 - The North Carolina Supreme Court held that “the source of corporate income cannot be disregarded, as extraordinary or infrequent transactions may well fall outside a corporation's regular trade or business. Again, the focus must be on the asset or property that generated the income and its relationship to the corporation's regular trade or business.”
 - When a “transaction involves a complete or partial liquidation and cessation of a company's particular line of business, and the proceeds are distributed to shareholders rather than reinvested in the company, any gain or loss generated from that transaction is nonbusiness income under the functional test.”

Allocation and apportionment (continued)



- N.C. Directive No. CD-01-1 (2001):
 - [G]ain or loss from a company's disposition of real or tangible property is classified as nonbusiness income and is allocated to the situs of the property if both of the conditions listed below apply. Gain or loss from a disposition that does not meet both conditions is classified as business income and is subject to apportionment. The conditions are:
 - The disposition is the liquidation of a separate and distinct line of business of the company and results in the cessation of that line of business.
 - The company distributes all of the proceeds of the liquidation to its shareholders and does not reinvest any of the proceeds in the company.
- Law change arguing transactional and functional test in 2002.
 - Prior to 2002 law change, business income was defined as:
 - Income arising from transactions and activity in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation's regular trade or business operations.
- So, what do we do now?
 - Which way will North Carolina likely argue under audit?
 - Remember...very limited and rare instances where income is defined as non-business income.

Allocation and apportionment (continued)



- A corporation must have business income from North Carolina and at least one other state to apportion and allocate its income.
 - When a corporation is only taxable in another state as a result of nonapportionable income, then all apportionable income is attributed to North Carolina.
- A corporation taxable both within and without North Carolina is required to use the allocation and apportionment provisions of G.S. § 105-130.4 to calculate its net income or net loss to North Carolina.
- A corporation is taxable in another state if:
 - The corporation's business activity in that state subjects it to a net income tax or a tax measured by net income; or
 - That state has jurisdiction based on the corporation's business activity in that state to subject the corporation to a tax measured by net income regardless of whether that state exercises its jurisdiction.

Allocation and apportionment (continued)



- “Business activity” includes any activity by a corporation that would establish a taxable nexus based on North Carolina standards for doing business in this State, except as limited by 15 United States Code, Section 381 (P.L. 86-272).
 - The filing of a unitary-combined return in another state with other related corporations does not, by itself, constitute “business activity” for purposes of determining if a corporation subject to income tax in this state is allowed to allocate and apportion income

Apportionment



- Single Sales Factor
- Sales of Tangible Personal Property:
 - If delivered or shipped to a purchaser within North Carolina (recipient in the state)
 - **Examples of North Carolina Sales:**
 - Taxpayer ships to the purchaser's central warehouse in North Carolina, but purchaser reships all goods to branch stores outside of North Carolina
 - A taxpayer in this State sold merchandise to a purchaser in State A. Taxpayer directed the manufacturer or supplier of the merchandise in State B to ship the merchandise to the purchaser's customer in North Carolina pursuant to the purchaser's instructions.
 - The taxpayer, a produce grower in State A, begins shipment of perishable produce to the purchaser's place of business in State B. While en route the produce is diverted to the purchaser's place of business in North Carolina where the taxpayer is subject to tax.

Apportionment (continued)



- North Carolina adopted Market based sourcing for tax years on or after January 1, 2020
- Receipts are in North Carolina if the taxpayer's market for the receipts is in North Carolina.
 - Sale of services to the extent delivered in North Carolina
 - Sales of intangibles to the extent the property is used in North Carolina
 - Examples:
 - Sales of stock = excluded from the factor
 - Sales of partnerships = excluded from the factor
 - Interest, Fees, and Penalties from Loans Secured by Real Property sourced to the location of the property
 - Interest, Fees, and Penalties from Loans Not Secured by Real Property sourced to location of the borrower
- If the market for a receipt cannot be determined, the state or states of assignment shall be **reasonably approximated**. In a case in which a taxpayer cannot ascertain the state or states to which receipts of a sale are to be assigned through the use of a method of reasonable approximation, the receipts must be excluded from the denominator of a taxpayer's sales factor.

Apportionment (continued)



- What is reasonable approximation? Used when trying to determine sourcing for licenses and sales of intangible property where the substance of the transaction resembles a sale of goods or services.
 - Related entity transactions: If a taxpayer has receipts from transactions with a related entity customer, information that the customer has regarding the sourcing of receipts from those transactions shall be imputed to the taxpayer.
 - Examples: Intercompany debt and related interest – how sourced?
- Exclusions from the sales factor (but included in the tax base):
 - Receipts from a casual sale of property
 - Receipts exempt from taxation
 - The portion of receipts realized from the sale or maturity of securities or other obligations that represent a return of principal
 - Receipts in the nature of dividends subtracted under G.S. §§ 105-130.5(b)(3a) and (3b) and dividends excluded for federal tax purposes

Transfer Pricing



- N.C. Gen. Stat. § 105-130.5A: Intercompany transactions that lack economic substance or are not at fair market value can cause a taxpayer to inaccurately report net income attributable to the state. If the Department determines a taxpayer has an intercompany pricing issue, the Department may redetermine the state net income of the corporation properly attributable to its business carried on in the State.
- August 2020 Transfer Pricing Initiative
 - Collections from North Carolina's Initiative were approximately \$114 million.
 - North Carolina's Initiative did not allow for prospective agreements.

Transfer Pricing (continued)



- Transfer pricing is generally governed by IRC § 482, (extensive) accompanying regulations, judicial decisions, disciplined procedures. North Carolina conforms to IRC § 482.
- Key components of the IRC § 482 regulations:
 - *Arm's Length Principle*
 - Results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.
 - *Best Method Rule*
 - A method that provides the most reliable measure of an arm's length result under the facts and circumstances of the particular transaction.
 - *Comparability*
 - Specific factors should be considered when determining comparability.
- IRC § 482 is not self-executing. It provides the IRS discretion to make adjustments.

Transfer Pricing (continued)



- Typical Intercompany Transactions Subject to Scrutiny
 - Transfer and licensing of intangible assets
 - Providing and charging for common services
 - Financing
 - Factoring accounts receivables
 - Sale of tangible goods that contain intangible (embedded intangibles)
 - Purchase and resale of tangible goods

Transfer Pricing (continued)



- Various states have contracted with RoyaltyStat for training, audit support, and access to transfer pricing databases, including North Carolina.
 - Other states include (e.g., AL, LA, etc.)
- North Carolina may look at comparables and disallow any of the following examples:
 - Negative comps;
 - Foreign inbound comparables; of
 - Those not in Royalty Stat or with three years of inconsistent data.

Transfer Pricing (continued)



How do I prepare for an audit?

- Ask whether the Department of Revenue is directly engaging an outside consultant
- Consider requesting direct access to discuss issues with the consultant rather than talking to a messenger (but consider privilege waiver issues)
- Ask direct questions about how the state is making adjustments – ask the Department of Revenue to identify which transactions are being adjusted, what they think the best method is, and to make correlative adjustments to the counterparty
- Beware of unreasonable document requests and elevate Department of Revenue attempts to use such requests for leverage
- Consider legal arguments beyond the transfer pricing rules
 - For example, consider whether an adjustment resulting in double taxation could be challenged on Constitutional grounds. States cannot delegate such legal issues to economic consultants
- Prepare commonsense analyses of outrageous implications of transfer pricing conclusions

North Carolina franchise tax



Taximposition



- All corporations doing business in the state are subject to the North Carolina franchise tax.
- How is corporation defined?
 - “Corporation” includes not only corporations in the usual meaning of the term, but also associations, joint stock companies, trusts and other organizations formed or operating for pecuniary gain which have capital stock represented by shares and privileges not possessed by individuals or partnerships.
- The term includes limited liability companies or partnerships that elect to be taxed as corporations for federal income tax purposes.

Tax imposition (continued)



- Holding companies are subject to special franchise taxes and are wholly exempt from the general franchise tax.
 - Capped at \$150,000 tax.
- Effective for taxable years beginning on or after January 1, 2020, a "holding company" is a corporation that satisfies at least one of the following conditions:
 - It has no assets other than ownership interests in corporations in which it owns, directly or indirectly, more than fifty percent (50%) of the outstanding voting stock or voting capital interests.
 - It receives during its taxable year more than eighty percent (80%) of its gross income from corporations in which it owns directly or indirectly more than fifty percent (50%) of the outstanding voting stock, voting capital interests, or ownership interests.
 - It owns copyrights, patents, or trademarks that represent more than eighty percent (80%) of its total assets, or receives royalties and license fees that represent more than eighty percent (80%) of its gross income, and it is one hundred percent (100%) directly owned by a manufacturer corporation with certain conditions.

Tax imposition (continued)



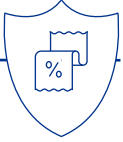
- “Doing business” is defined for purposes of the franchise tax as each and every act, power, or privilege exercised or enjoyed in North Carolina proceeding from the powers and privileges granted by the laws of the state. (Sec. 105-114(b)(3), G.S.)
- Public Law 86-272 does not prevent imposition

Tax imposition (continued)



- “Managed” or “controlled” in North Carolina is deemed to be nexus
- Be weary of:
 - North Carolina companies with officers with signatory authority
 - Chains of holding companies with North Carolina nexus
 - Foreign inbound with limited management in the U.S., but North Carolina officer(s) and operations

Taxbase



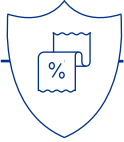
- Prior to 2022, the franchise tax base was based on the greater of three calculations: a proportion of the corporation's net worth, 55% of the corporation's appraised value, or the corporation's actual investment in tangible property in the state
- Pursuant to Senate Bill 105 (signed Nov. 18, 2021), effective for tax years beginning on or after January 1, 2023 (applicable to the calculation of the franchise tax reported on the 2022 return), the franchise tax is determined by measuring a corporation's net worth.

Taxbase (continued)



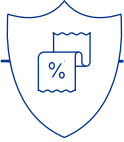
- For years prior to 2023, is there a tax refund opportunity?
- Tennessee, like North Carolina, imposed franchise tax on the greater of apportioned net worth, or the actual value of real and tangible personal property owned or used in Tennessee
 - The property measure is repealed effective for tax years ending on or after January 1, 2024
 - The property tax base was found to be unconstitutional
 - Is there an opportunity to file a refund claim for North Carolina franchise tax paid on property tax bases prior to 1/1/23?
 - Litigation, if feasible, could invalidate the entire tax or just invalidate the property tax bases
 - Time is running on statute of limitations for filing a refund claim
 - Are there other events which could keep the statute of limitations open?
 - Federal RAR: Statute likely stays open for everything, including franchise tax
 - File Form NC-14: Notice of Contingent Event or Request to Extend the Statute of Limitations
 - Taxpayers are filing refund claims for (1) refund of entire franchise tax, or (2) refunds of franchise tax on property tax bases only.

Taxbase



- A corporation's net worth is defined as the total assets of the corporation without regard to deductions for accumulated depreciation, depletion, or amortization minus total liabilities.
- In determining net worth, the following adjustments are required:
 - A deduction for accumulated depreciation, depletion, or amortization allowed for federal income tax purposes.
 - Assets that are allowed a deduction for depreciation, depletion, or amortization for federal income tax purposes are valued under the same method used for computing depreciation, depletion, and amortization.
 - An addition for the amount of affiliated indebtedness owed to a parent, subsidiary, affiliate, or noncorporate entity
 - Owned directly or indirectly greater than 50%
 - The creditor corporation that is subject to franchise tax may deduct the amount of indebtedness owed to it by a parent, subsidiary, or affiliated corporation to the extent such indebtedness has been added by the debtor corporation in computing its franchise tax liability.

Taxbase (continued)



Philip Morris USA, Inc. v N.C. Dep't of Rev. (Off. Admin. Hearing Dec. 30, 2021)

- The North Carolina Office of Administrative Hearings (OAH) addressed the constitutionality of statute that allowed a deduction from the corporate franchise tax base only for receivables owed to the taxpayer by related corporations doing business in the state
 - Two adjustments to the capital stock base (a part of the calculation of the franchise tax base) were at issue in the dispute
 - The first required a taxpayer to add back to the capital stock base amounts owed to affiliate corporations; the other adjustment required a corporation to deduct from the capital stock base amounts owed to it by affiliate corporations to the extent that the receivables were not included in the affiliate debtor's capital stock base under the first adjustment
- The OAH first concluded that the taxpayer could proceed with a claim that the statute was unconstitutional as applied to it without first having to establish that the statute was capable of constitutional applications
- Because the law denied the taxpayer a deduction for certain of its affiliate receivables, while a corporation that loaned only to affiliates that do business in North Carolina was permitted to deduct all its affiliate receivables, it was clearly discriminatory in violation of the Commerce Clause

Questions?



Thankyou





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