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BTC Brief

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FAIR TAX PENALTIES: A Hollow Solution to the Real Problem of Aggressive Corporate Tax Avoidance

Timely, accessible, and credible analysis of state and local budget and tax issues

Summary:

SB 1172, Fair Tax Penalties, would eliminate the ability of the Department of Revenue (DOR) to levy penalties when, after forcing affiliated corporations to file a consolidated tax return, the DOR determines that the parent company and its affiliates did not accurately report their "true earnings" attributable to doing business in North Carolina. Taking away the authority of the DOR to levy tax penalties would only serve to encourage aggressive tax avoidance by large, multi-state corporations. Enacting mandatory combined reporting – now the law in the majority of states that levy a corporate income tax – is the only solution to ensure that all businesses are treated fairly, ensure that businesses have adequate guidance as to how their tax liability should be calculated, and do away with the aggressive tax avoidance strategies that have drained the state's revenue coffers and given multi-state corporations an unfair advantage over smaller, in-state businesses.

Overview

North Carolina is one of 45 states that currently levy a tax on corporate profits. In the majority of these states, affiliated corporations must file joint tax returns. But in North Carolina, affiliated corporations must file separate tax returns unless the Department of Revenue requires them to file a consolidated return. If the DOR forces a corporation and its related entities to submit a combined tax return for previous years and then determines that the companies substantially underpaid the state taxes owed, it can demand the back taxes and assess a 25-percent "large tax deficiency" penalty (§ 105-236(a)(5).

At the moment, the General Assembly is considering legislation that would weaken the state's ability to deter aggressive corporate tax avoidance. Specifically, SB 1172 would repeal of the NC Department of Revenue's authority to levy the 25-percent tax penalty.

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Tax penalties can be justified when a consolidated return is ordered

Being a "separate entity" state has made North Carolina vulnerable to various income-shifting strategies employed by large, multi-state corporations. Over time the General Assembly has responded by passing legislation disallowing specific strategies as they are discovered. The majority of states, most recently West Virginia and Wisconsin, have chosen to address these strategies in a comprehensive way by enacting "mandatory combined reporting," a tax reporting structure in which affiliated corporations must file one return that combines the profits of all of the entities. From this combined return a certain share of the combined net profits are apportioned to North Carolina based on a formula that accounts for the share of payroll, property and sales in North Carolina.

Since 1941, under §GS 105-130.6 the Secretary of the Department of Revenue has had the authority to force affiliated corporations to file consolidated returns in order to accurately assess the "true earnings"

that resulted from doing business in North Carolina. If the new tax assessment of the affiliated companies is 25 percent greater than the cumulative tax assessment of the separate returns, then the DOR has the authority to levy a 25-percent tax penalty in addition to requiring the companies to pay the new assessment plus interest.

The DOR usually settles with companies found to owe additional taxes through this process. Because the specifics of these settlements are known only to the DOR and the companies, it is impossible to make an independent determination as to whether these companies intentionally used the separate entity filing status to deliberately underreport their "true earnings." However, two recently litigated cases make a compelling argument to leave in place the department's authority to levy penalties. In these high-profile cases involving Wal-Mart and Food Lion (Delhaize), the evidence presented show the companies clearly restructured their operations not for legitimate business purposes but with the clear intent to reduce their state tax liability in North Carolina and elsewhere. After restructuring they were able to move expenses and income around in ways that had no "economic substance" but instead had the exclusive purpose of shifting income into lower tax states or states where they have no tax nexus. Moreover, the accounting firms involved in designing these schemes, such as Ernst and Young, have undoubtedly sought to peddle their tax avoidance strategies to many more companies.

Concerns with current NC corporate tax law

Proponents of SB 1172 contend that the Department of Revenue does not offer sufficient guidance to companies as to how their actions would be viewed in the event that an audit of the companies triggers the DOR to force them to file a consolidated return. This is a compelling argument; however, if the DOR does issue such guidelines and makes them publicly available, companies can use that information to argue that their practices did not technically violate the DOR's guidelines. Moreover, issuing such rules and guidelines could encourage the accounting firms that specialize in tax avoidance strategies to find ways around these rules.

Under the DOR's current policies, companies that, after being forced to file a consolidated return, are found to have significantly underpaid their taxes can apply for a waiver of the 25-percent penalty. Companies are entitled to such a waiver once every three years if it is determined that the company did not intentionally use the separate entity filing status in order to understate earnings.

Proponents of SB1172 also contend that once a company has been forced to file a consolidated return, it should be the extent to which this new return understates income that determines whether or not a penalty should be levied. In fact, forcing a consolidated return is a tool that is available to the DOR to determine the true tax due, not an entirely new process that triggers a new beginning point from which understating income would be determined.

Potential revenue implications

There are potentially negative revenue implications from the Fair Tax Penalties legislation. In FY 2009-10 the Department of Revenue collected, partly with the help of the threat of penalties, an additional $424 million in tax revenue for the General Fund. All three budget proposals presented this year (governor, House and Senate) include an additional $110 million in General Fund revenue from the DOR's ongoing efforts to conduct audits, force consolidated returns and then collect the back taxes owed. The Department of Revenue uses the threat of the 25-percent underpayment penalty to encourage companies that owe back taxes to settle quickly and thereby have the penalty waived. Without this leverage, there would be little incentive for companies not to litigate their new assessments. If SB 1172 were enacted, even if the companies eventually lose these lawsuits, the consequence would only be to pay the back taxes owed plus modest interest.

Conclusion

North Carolina's current corporate income tax law leaves the state vulnerable to companies that are looking to hide their true earnings in the state. Businesses that cannot, or chose no to, take advantage of tax avoidance schemes are put at a competitive disadvantage under the current system. Moreover, the current legal structure also deters the DOR from issuing guidance that could be helpful companies that may have legitimate business reasons for setting up separate, but affiliated, entities. The solution to these two problems is not to eliminate the DOR's authority to levy tax penalties, but is rather to do what the majority of states have done and enact mandatory combined reporting.