



December 12, 2016

North Carolina Department of Revenue
Lennie Collins
Director
Income Tax Division
PO Box 871
Raleigh, NC 27602

Director Collins,

On October 3, 2016, the North Carolina Department of Revenue (NCDOR) proposed new administrative rules (Proposed Rules) in the North Carolina Register pursuant to the authority granted by section 38.4 of H 1030 (S.L. 2016-94). If the Proposed Rules stand, they would implement a market-based sourcing for apportionment purposes.

On behalf of National Taxpayers Union's (NTU) North Carolina members, I urge you to reject the Proposed Rules on market-based sourcing regulations. Specifically, NTU has deep reservations about the proposal's shift to an audience-based corporate tax apportionment system.

Over the last couple years, North Carolina has led the way in simplifying its tax code by broadening the tax base and lowering marginal tax rates. On January 1, 2017, the state's corporate income tax will drop an additional point – from 4 percent to 3 percent. These changes have made the state's tax system more competitive, which has paid enormous dividends for the state. Despite these positive steps, NCDOR's Proposed Rules would take the state backward, particularly with respect to its corporate income tax.

Before explaining the defects with NCDOR's Proposed Rules, it is important to highlight the process by which content is largely delivered in the 21st century. Content creators – NBC Universal, for instance – produce content such as television programs. The content creators then contract with distributors – local affiliates, or Internet distributors such as Hulu or Netflix – to market and deliver the content to viewing audience, i.e., consumers. Content creators are simply manufacturers and wholesalers, while intermediaries distribute content directly to consumers.

NCDOR's proposed audience-based apportionment of corporate income taxes to content providers is outdated and unworkable. The framework for this archaic approach as applied to content providers was first conceived in 1957 as part of the Uniform Division of Income for Tax Purposes Act (UDITPA). Given the rapid advances in technology, UDITPA's treatment of content providers, as proposed by NCDOR, fails to properly account for such changes. If implemented, North Carolina would join only Massachusetts to embrace this antiquated method in recent years.

Using the audience-based method is flawed for two primary reasons. First, according to Richard Pomp, a tax law professor at the University of Connecticut School of Law, the audience-based method of apportionment is “defective because it conflates the advertiser’s market with that of the content providers. The audience factor attempts to calculate the percentage of viewers by state, but these viewers are not the customers of the content providers. ... [T]hey are customers of: the local broadcast affiliates; the local cable affiliates; the Internet distributors like Hulu, Vudu, RIM, Amazon, Google, Yahoo, Apple, or Netflix; or satellite distributors like Dish TV or DirecTV.” In short, content providers create content, but do not deliver the content to the consumers; distributors deliver content to consumers.

Additionally, compliance and administrability are significant hurdles inherent in the Proposed Rules. Again, because content creators contract with distributors, who then contract with consumers for delivery of content, content creators do not have a direct relationship with the viewing audience. As a consequence, content creators do not have the requisite information – billing information, for instance – about the location of the consumers of the content in order to determine their tax liability. By and large, content creators derive no revenue directly from viewers.

NTU is thankful for North Carolina’s positive contributions to pro-growth tax reform over the last few years. The Tar Heel State’s bold, comprehensive tax reform is truly a model worth emulating for other states. Adopting an audience-based approach to apportionment would be a retreat from the otherwise positive changes you have enacted recently. Accordingly, NTU strongly urges you to reject the Proposed Rules.

Sincerely,

A handwritten signature in black ink, appearing to read 'CPA', with a stylized flourish at the end.

Clark Packard
Counsel and Government Affairs Manager