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Tax Policy

Criss-crossing the country, Crowell & Moring's state tax team meets regularly with state secretaries of revenue and their counsel to bring Bloomberg BNA's readers candid and timely observations from the country's top state tax decision-makers. Well into this 50-state journey, Don Griswold, Walt Nagel, and Jeremy Abrams spoke this month with North Carolina Secretary of Revenue Lyons Gray. In this column, Gray discusses the revenue department's role in the legislative process, recently implemented tax reform, and the advantages of doing business in the Tar Heel State, among other topics.

Crowell's Conversations: An Interview With Lyons Gray, North Carolina Department of Revenue



LYONS GRAY, INTERVIEWED BY DON GRISWOLD,
WALT NAGEL, AND JEREMY ABRAMS

Listen, Learn, Help, and Lead

CROWELL: We're sitting here on this beautiful spring morning in Raleigh with North Carolina Secretary of Revenue Lyons Gray. Thanks for having us.

GRAY: It's a pleasure to speak to you all today. I hope you'll enjoy the view of old Historic Oakwood while we chat.

CROWELL: Let's start with your impressive background which includes numerous positions, spiced up with civic and philanthropic service on multiple fronts. You seem to have transitioned effortlessly from running your own business to serving in government – including holding elective office in the North Carolina General Assembly – to your current role as secretary of revenue.

GRAY: I can't keep a job!

CROWELL: You even spent several years down the block from Crowell's office in Washington when you were appointed by then President George W. Bush to serve as CFO of the Environmental Protection Agency.

How has your career led you here and prepared you for the role you've got?

GRAY: My idea in the beginning was to go work for one person, stay there for 40 years, and then retire with the gold watch. However, each different experience has been of value to me in helping learn how to manage. My subject knowledge in each area was always suspect, but I learned from each experience. For example, when I was a young freshman in the North Carolina General Assembly, I was going around trying to line up votes on my first bill, which was to ban lead acid batteries in our landfills. One fellow said, "Oh yes, I'm going to vote for that," but when it came to a vote on the floor he voted "no." So I asked "Why sir did you vote against the bill?" and he responded by using some profanity and told me what he thought of me. I learned right then and there that people's integrity does matter. This encounter led me to a little philosophy I use that's called, "Listen, Learn, Help, and Lead." I realized early on that if I didn't listen, then I wasn't learning. If I didn't learn, I couldn't help. If I didn't help, I couldn't lead. I always thought if I could stay true to this philosophy then I'd be all right.

CROWELL: How do you apply that philosophy in leading the department?

GRAY: I'm trying to create a culture and atmosphere where people feel comfortable doing the right thing. I get asked my opinion from time to time on proposed legislation, which is fine. However, I'm not a policy maker, nor am I injecting politics into this department. We administer the tax laws. People come to me and say, "Mr. Secretary that is a terrible bill," to which I respond, "Sir, I administer the law. If you don't like the bill, the General Assembly is 100 yards that way." I'm trying to create an atmosphere where we do what we're supposed to do, collect not a penny more, not a penny less, but do the right thing. Of course, if everybody did the right thing they wouldn't need me here.

"I'm trying to create an atmosphere where we do what we're supposed to do, collect not a penny more, not a penny less, but do the right thing."

CROWELL: The department must have some role in shaping the state's tax laws, right?

GRAY: Yes, the department has a legislative liaison and subject matter experts within our Tax Administration division that are very active with the General Assembly. In a lot of cases, we will seek clarification on how a new statute should be applied to certain situations. If the General Assembly leadership or the Finance Committee wants to address a particular issue, they will seek our input from a revenue administration perspective. What kind of compliance issues do you see? What kind of personnel are you going to need to do that? Will your computer system allow for this? Practical considerations of this nature are often asked of our agency. However, I am not over there saying, "You ought to reduce the tax rate on this or raise the tax rate on that." That's their decision and we do not get involved in the policy debate.

CROWELL: So the taxpayer community may be coming to the department as well as to the legislature and you're a conduit for that?

GRAY: Absolutely. Let's take protective refund claims for example. We recognized that there were entities that were filing protective refund claims for a variety of reasons. Whether related to litigation or audits from other states or the IRS, we realized these claims could be significant and go for a long period of time. Long-term, unverified refund liabilities represented a significant disruption to the department's planning capabilities and left some taxpayers without recourse for obtaining an accurate assessment of their liabilities for events outside of their control. We just wanted the General Assembly to clarify what the rules were so we could do the right thing. The new law provides an exception to the general statute of limitations for obtaining a refund of an overpayment due to a contingent event or an event or condition other than a contingent event.¹ This creates a level playing field for taxpayers and allows us to better prepare and plan for refunds that might be due to taxpayers.

Challenges at the Department

CROWELL: You were appointed secretary by Governor (Pat) McCrory (R) and sworn into office on Jan. 5, 2013. What's been your biggest challenge over the past year and a half?

GRAY: My leading challenge has been the cancellation of a long-standing IT initiative known as the TIMS project which involved the replacement of our current tax processing system. It became clear to me after the first few months that this department is now an IT-driven enterprise and that the system we were using was 20 years old and did not anticipate electronic filing as we know it today. We're getting over 10 million tax returns a year, over eight million of those are coming electronically and the other two million we physically open and scan. Earlier administrations had understood that we needed to update our IT program to meet today's needs. Unfortunately, the vendor was unable to meet some deadlines that they had agreed to. So while the intention of the TIMS initiative was indeed worthy, after close inspection of the project status and future, I made the difficult decision to go in another direction and now we're in the process of seeking a new vendor to meet our needs.

CROWELL: One of the things you're looking at with that vendor is to make sure that North Carolina doesn't repeat the problem that South Carolina experienced with the security breach, right?

GRAY: We wish no ill on our neighbors. That happened shortly before I arrived at the department and my first question was "How secure are we?" I learned we're so secure that I can't even access our mainframe on my personal laptop. This is good considering the kind of mischief I could get into, right. So that's good. Like I said earlier, everywhere I turn things are becoming IT driven. IT security is not an expertise or a background that I have, so again I'm listening and learning so that I can try to be the best help I can and lead this process.

¹ N.C. Gen. Stat. § 105-241.6(b)(5), as added by 2013 H.B. 14, effective Jan. 1, 2014.

Tax Reform

CROWELL: Many states have had a tough time passing tax reform in recent years. What made that doable for North Carolina?

GRAY: Everybody talks about tax reform as a campaign issue, but until you've got the votes and a governor to sign the bill, you don't have anything. Enacting tax reform for North Carolina was a leading goal of both the governor and the General Assembly when entering the 2013 legislative session. Restructuring the code to lower tax rates and encourage investment in our state was a big step forward in the effort to recruit industry to North Carolina.

CROWELL: Do you expect to meet the revenue goals that would allow corporate income tax rates to be reduced even further as the new legislation provides for, or is it too early to tell?

GRAY: Over the next year I think we will learn quite a bit more about the effects of the tax reform package. We're actually taking in a little less money because the tax rate was lowered for every taxpayer. In order to flatten out the revenue picture they've expanded a number of items that are subject to sales tax, such as newspapers, admissions to certain events and things like that. We're headed toward a much more consumption-based tax structure. That is, if you're going to use a service or buy an item, you will be participating in our tax process. Sales tax revenues, interestingly enough, are actually up a little bit.

“We're headed toward a much more consumption-based tax structure.”

CROWELL: For many businesses, particularly out-of-state companies, it may be easier to share concerns with the tax folks with whom they interact at the department as opposed to members of the legislature. Was the corporate taxpayer community actively involved in the tax reform process and is it appropriate for corporations to talk to the department when tax reform is taking place?

GRAY: There are two ways to look at that. We're happy to welcome people into this department to chat and learn their issues, but when you get down to the reality of it, they need to work with the legislature and in the case of those firms that may be headquartered outside the state, they may employ lobbyists in the area to express opinions on whatever the issues might be. We are happy to hear from both the corporate and private communities as well, especially individuals running S corps. and LLCs. In these conversations, we do actually suggest that they visit with members of the Finance Committee on both the Senate and the House side to make sure members of those committees understand that company's issues or that industry's issues. Whether it's the hotel/motel industry, tobacco, textiles, the furniture presence that we used to have, or the burgeoning and growing IT industry in the state, the scope of issues can be pretty wide. The bottom line is that in order to pass legislation of this magnitude, the General Assembly would need buy-in and advice from a number

of actors. Engaging and working with business leadership is a critical element to ensure legislation is crafted in a manner that supports the operations within this community.

CROWELL: A possible subject in future corporate income tax reform is single sales factor apportionment and a potential shift in sourcing of intangibles and services from where the income-producing activity is performed to where the customer is located or receives the benefit. Has the department taken a position on whether North Carolina ought to change its apportionment formula or sourcing methodology for sales?

GRAY: We really don't take a position concerning any shift in apportionment formula or sourcing rules. Frankly, our focus remains on implementing changes to the tax code found in the Tax Simplification and Reduction Act passed last legislative session. However, the department is aware of other states that have shifted to a "market sourcing" approach and we are monitoring the successes and challenges they face in implementing that new approach.

CROWELL: Regardless of what formula a state adopts, it doesn't necessarily work in every situation and occasionally the statutory rules malfunction for a particular taxpayer. Will you allow a taxpayer to use an alternative apportionment formula if necessary to cure such malfunction?

GRAY: If a company comes to us and says that the standard does not properly reflect its business activity in North Carolina and then provides us with details about why they believe that's the case, we'll review that request on a case-by-case basis. I think there are perhaps more companies that are creative in looking at ways to reduce state tax liabilities and certainly alternative apportionment is a method to do that, but ultimately I have to approve it. And occasionally I'm called on to make a decision or two and I make them based on the best information that I have at the time. What are the implications? What are the potential unintended consequences down the road? What are we looking at here? Are we being consistent?

Reflecting on *Delhaize*

CROWELL: Many taxpayers were disturbed by the *Delhaize* litigation and the positions the department took on combined reporting a couple years ago. It's hard for many corporate taxpayers to understand why the department would seek, and why the Court of Appeals ultimately would uphold, penalties for a taxpayer when the taxpayer followed the separate-entity reporting required by statute. Do you think the courts got it right in *Delhaize*?²

GRAY: What you've identified was a lack of guidance. And I think since then, I'm looking for clarification. I wasn't here for *Delhaize*, of course, so I'm not going to opine. I think in the end the courts probably got it right but that's my opinion. But again, I would also say that every Secretary is faced with these kinds of issues and they try to make a decision based on the best information they have at the time and I believe, since *Delhaize*, the legislature has given us more clarification.

² *Delhaize America Inc. v. Lay*, 731 S.E.2d 486 (N.C. Ct. App. 2012).

Are there always going to be challenges? You bet. That goes with the role of the department. Our job again is to administer the law, to take not a penny more, not a penny less, but follow the direction we've been given.

CROWELL: Tell us about the new amnesty program for so-called trust taxes that the department recently announced.

GRAY: We don't call it amnesty, as only the General Assembly can authorize an amnesty program. It's a department compliance/collection initiative and it includes withholding, sales/use taxes, motor vehicle lease taxes and other trust taxes. We're trying to encourage folks to do the right thing. If they withhold from someone's paycheck and don't send it in, then that's not good. We're not trying to be the strong hammer of the law. We'll work with people and give them that opportunity to do the right thing, and if they choose not to, then other action is taken. Our goal is to encourage and educate taxpayers to do the right thing, especially on trust taxes, because you're dealing with somebody else's money. Unfortunately, sometimes business owners fall short on this requirement, and it's incumbent on us to collect what is duly owed. Part of our goal in being the Department of Revenue is to educate. And, if we can raise the level of compliance by educating, then we will have achieved some of that goal. The initiative is still open and it's a great opportunity for businesses to work with us to ensure all trust tax liabilities are met.

The Tar Heel Advantage

CROWELL: Why should businesses expand or relocate to North Carolina?

GRAY: I was born and raised in this state. I've had the opportunity to go work in other states, and I've always come back. And, people would say, "Well, why didn't you stay in Washington," or, my first job was in Detroit, "Why didn't you stay in Detroit?" Because I love this state. Why do I love this state? The best work force in the world. Great quality of life. We have four seasons and we appreciate that. People still stop and speak to each other on the sidewalk. "How you doing?" "Doing great."

CROWELL: I'm from Missouri, we do that too. I can't speak for New Jerseyans like Walt and Jeremy!

GRAY: But obviously that's not all that's needed to create a vibrant economy. There are many factors that drive North Carolina's competitiveness within the cor-

porate community. First, like I said, the quality of life in our state is unmatched. This serves as a key distinguishing factor when corporations decide what area may be best suited for their employees and their families. Second, our administration is committed to creating a business-friendly environment—whether through tax reform or investment in important infrastructure. Next, we are working with our community colleges and university systems, trying to create the job skills and trying to anticipate future needs. Another thing that appeals to people is international flights in two major airports in our state. You can get to Europe or the Far East from either Charlotte or Raleigh-Durham. That's important. Now, the danger is that the rest of the state may not see that growth. So, how do we balance it? And, as we look at people and products, how do we make it available for people to move things? If you're in the far west in Asheville or the east coast in Wilmington, how do you get people and products moved around? So, we're looking at new ways to affect those changes.

We're in a global economy now. We compete against China, Germany and the people of the world. It's not just us competing with Virginia, Tennessee and South Carolina anymore. Last week, Toyota announced they were moving their North American headquarters to Dallas. North Carolina was on the final list. Why didn't they come here? How do we make ourselves attractive? It is a shift, but when you are looking at particular projects that might bring significant jobs and employment to this state, certainly there's always an eye around your geographic area. If you have a state that has a single sales factor formula and we're a double-weighted sales factor state, for example, that could be a selling point for them. We may look at that and say well perhaps a competitor has a single sales factor but our rates are less or their sales tax rates are higher. You have to look at the whole universe of taxation. I try to make sure that all members of the economic development team — be it the governor's office, the Commerce Department, Department of Revenue, legislature and all — fully understand our tax laws as they go and seek industry to come and be part of our state. How do we best present ourselves? With everybody hopefully having a seat at the table.

CROWELL: We're glad to have had a seat at the table with you this morning. Thanks for chatting with us.

GRAY: My pleasure.