2008
NORTH CAROLINA STATE AND LOCAL TAX UPDATE

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Introduction

This manuscript is not designed to provide an exhaustive analysis of all the North Carolina state and local tax issues facing tax practitioners in North Carolina on a daily basis, nor is this manuscript designed to describe all of the differences that exist between federal and North Carolina tax systems. Instead, this discussion will review some of the more interesting recent North Carolina tax developments which have arisen in the last year or so.

In this discussion, we will review some of the more interesting legislative developments which have transpired during the most recent summer legislative sessions. In addition, we also will review some of the recent court cases involving North Carolina and local tax issues, as well as certain Department of Revenue procedural changes of interest to North Carolina state tax practitioners.

Please note that this manuscript went to print on **May 22, 2008**, and therefore this manuscript may not include all of the most recent North Carolina Department of Revenue pronouncements or court cases.

PART ONE
PERSONAL INCOME TAX DEVELOPMENTS

I. North Carolina Supreme Court Upholds 2001Tax Rate Increase and Holds That The 2001 Tax Rate Increase Was Not A Retroactive Tax Assessment.

The North Carolina Supreme Court issued its decision in Coley v. North Carolina on June 30, 2006. This North Carolina Supreme Court case has confirmed that the 2001 individual income tax rate increase does not violate the North Carolina Constitution's prohibition against a retroactive application of a tax rate increase.

Note: We are waiting to hear whether there will be an appeal to the U.S. Supreme Court.

II. Highest Individual Income Tax Rate of 8.25% Has Been Reduced!

The personal income tax rate applied to higher income individuals is reduced from 8.25% to 8% for the 2007 taxable year and to 7.75% beginning with the 2008 taxable year. Previously, the increased tax rate of 8.25% applied to upper income taxpayers was scheduled to expire on January 1, 2008.

Senate Bill 1741 (effective July 1, 2006).

III. Personal Earned Income Tax Credit Enacted.

Effective for taxable years beginning on or after January 1, 2008, an individual, who claims for the taxable year an earned income tax credit under IRC §32, is allowed a **"refundable"** North Carolina personal income tax credit equal to 3.5% of the amount of credit the individual qualified for under the IRC §32. If the credit exceeds the amount of tax imposed for the taxable year (reduced by the sum of all credits allowable), the Secretary must **refund** the excess to the taxpayers. Thus, the new North Carolina Earned Income Credit is a **"refundable"** credit.

Note: The state earned income tax credit is repealed effective for taxable years beginning on or after January 1, 2013.

Ch 323 (H.B. 1473) (2007).

IV. Long-Term Care Credit Reenacted.

Effective for taxable years beginning on or after January 1, 2007, a taxpayer whose adjusted gross income (AGI) - as calculated under the IRC - is less than the amount listed below, is allowed a personal income tax credit in the amount of 15% of the premium costs the taxpayer paid during the taxable year on a qualified long-term care insurance contract. The credit was formerly available for taxable years 1999 through 2003.

The long-term care insurance contract must offer coverage to the taxpayer, the taxpayer's spouse, or a dependent for whom the taxpayer was allowed to deduct a personal exemption under IRS §151(c) for the taxable year. The credit may not exceed **$350 for each qualified long-term care insurance contract** for which a credit is claimed.

AGI limits, for purposes of the credit, are as follows:

- for those filing on a married, filing jointly basis, $100,000;
- for those filing on a head of household basis, $80,000;
- for those filing on a single basis, $60,000; and
- for those filing on a married, filing separately basis, $50,000

Note: The long-term care credit is repealed for taxable years beginning on or after January 1, 2013. CH 323 (H.B. 1473) (2007).

V. Adoption Credit Enacted.

Effective for taxable years beginning on or after January 1, 2007, an individual, who is allowed a federal adoption tax credit under IRC §23 for the taxable year, is allowed a personal income tax credit equal to 50% of the amount of the federal credit allowed.

Note: This credit is repealed effective for taxable years beginning on or after January 1, 2013.

CH 323, House Bill 1473 (2007).

VI. The New Parental Savings Trust Fund

A. Introduction. Applicable to taxable years beginning after 2005 and before 2011, personal income taxpayers with federal adjusted gross incomes below specified levels may claim a deduction of amounts contributed to an account in the Parental Savings Trust Fund of the North Carolina State Education Assistance Authority (the "North Carolina Section 529 Plan").

B. **<u>2006 Tax Rules</u>.** For 2006, the limit on the amount of the North Carolina personal income tax deduction that may be claimed for contributions to an account in the Parental Savings Trust Fund of the State Education Assistance Authority was $750 for individual filers and $1,500 for married taxpayers filing jointly.

Under the 2006 changes, beginning with the 2007 taxable year, the limit on the amount of the North Carolina personal income tax deduction that may be claimed for contributions to an account in the Parental Savings Trust Fund of the State Education Assistance Authority was increased from $750 to $2,000, and from $1,500 to $4,000 for married taxpayers filing jointly.

The federal AGI levels are $100,000 for joint filers, $80,000 for heads-of-household, $60,000 for single filers, and $50,000 for married, filing separately.

An addition adjustment must be made for any amounts withdrawn from the account that are not used to pay for the qualified higher education expenses of the designated beneficiary, **<u>unless</u>** the withdrawal was made due to the death or permanent disability of the designated beneficiary.

S.B. 1741 (effective July 1, 2006) and Ch. 221 (S.B. 198), Laws 2006, effective as noted above.

C. **<u>2007 Tax Changes</u>**. Effective for taxable years beginning on or after January 1, 2007, a single taxpayer may deduct, from taxable income, an amount not to exceed $2,500 (formerly $2,000) contributed to an account in the Parental Savings Trust Fund of the State Education Assistance Authority. In the case of married couples filing a joint return, the maximum dollar amount of the deduction is $5,000 (formerly $4,000).

Formerly, a taxpayer could claim the deduction only if the taxpayer's adjusted gross income was less than the amounts indicated in the statute. **The AGI limit has been removed until 2012!**

Moreover, effective July 31, 2007, but applicable to taxable years beginning on or after January 1, 2012, only taxpayers whose adjusted gross incomes are less than the following amounts for their filing status are eligible to claim the deduction: $100,000 for married filing jointly; $80,000 for heads of household; $60,000 for single taxpayers; and $50,000 for married taxpayers filing separately.

CH 323 (H.B. 1473) (2007).

VII. Individual Joint Filing Permitted, Even If One Spouse is Not a N.C. Resident.

Beginning with the 2006 tax year, married taxpayers are allowed (but not required) to file a joint personal income tax return **even** if one spouse is not a North Carolina resident and has no North Carolina taxable income. Previously, if one spouse was a nonresident and had no North Carolina taxable income for the taxable year, the spouse that was a North Carolina resident, or who had North Carolina taxable income, was required to file a married, filing separate return.

Senate Bill 1741, Laws 2006, effective January 1, 2006.

Note: This new provision will benefit families of US armed forces with husbands or wives who are stationed overseas or in other states.

VIII. New Rules for Conservation Donations.

A. Background: Credit for Certain Real Property Donations. Under N.C.G.S. 105-151.12, an individual taxpayer, that makes a qualified donation of an interest in real property for **land conservation purposes**, is allowed a North Carolina tax credit equal to 25% of the fair market value of the donated property.

Under 1998 legislature amendments, effective for tax years beginning January 1, 1999, the total amount of the credit allowable under this section was increased from $100,000 to $250,000. Also, for tax years up through 2005, the maximum dollar limit that applies in determining the amount of the credit applicable to a partnership that qualifies for the credit applies separately to each partner. N.C.G.S. 105-151.12(f).

In addition, before the 1998 tax law changes, in order to claim the tax credit, the taxpayer had to increase his or her taxable income by the fair market value of the donated property (up to a maximum of $400,000). Presumably, this “add-back” to state taxable income was designed to prevent taxpayers from obtaining a double tax benefit for North Carolina state tax purposes which would be available by claiming both the conservation credit as well as the charitable donation deduction. However, effective for tax years beginning on or after January 1, 1999, the “add back” has been repealed which presumably will now permit taxpayers to a **double tax benefit** for qualified conservation property donations.

B. 2006 Tax Changes: Real Property Donation Credit Extended. S.B. 1741 (effective July 10, 2006) made two significant changes to the conservation donation rules.

First, the **"sunset" date** for the real property donation credit was extended to January 1, 2007 (previously January 1, 2006).

Second, for tax years up through 2006, the maximum dollar limit that applies in determining the amount of the credit applicable to a partnership that qualifies for the credit applies separately to each partner. N.C.G.S. 105-151.12(f). This favorable provision was scheduled to expire on December 31, 2005, but was extended for the 2006 tax year.

C. 2007 Changes to Credit for Donation of Real Property for Expanded Conservation Purposes. Session Law 2007-309 (H.B. 463) made numerous changes to N.C.G.S. 105-130.34.

(1) Expanded Definition of "Qualified Conservation" Property. First, the North Carolina corporate income tax and personal income tax credits for donations of real property for conservation purposes are now also available for a donation of an interest in real property that is "useful for forestland or farmland conservation, watershed protection, conservation of natural areas, conservation of natural or scenic river areas, conservation of predominantly natural parkland, or historic landscape conservation." This change expands the types of property donations eligible for the credit.

A qualified donation made by any C corporation (formerly, any corporation) or by an individual or pass-through entity (formerly, a person) is eligible for the credit.

(2) Appraisal Report Now Must Be Submitted to Support Claim for Conservation Credit. However, to support any conservation donation credit, the taxpayer now must file, with the income tax return for the taxable year, a self-contained appraisal report or summary appraisal report as defined in the latest edition of the Uniform Standards of Professional Appraisal Practice. For fee simple absolute donations of real property, the taxpayer may submit documentation of the county's appraised value of the donated property, as adjusted by the sales assessment ratio, in lieu of an appraisal report.

(3) New DENR Certification Requirement. Also, the taxpayer must submit a certification by the Department of Environment and Natural Resources that the donated property is suitable for one or more of the valid public benefits set forth in the revised N.C.G.S. 105-130.34.

(4) Maximum Annual Credit for Individuals. The aggregate amount of credit allowed to an individual in a taxable year for one or more qualified donations, whether made directly or indirectly as owner of a pass-through entity, may not exceed $250,000. **However, in the case of property owned by a husband and wife, the aggregate amount of credit allowed to a husband and wife filing a joint North Carolina income tax return may not exceed $500,000 in a taxable year.**

Formerly, a $250,000 annual cap applied to persons filing an individual income tax return.

(5) Maximum Annual Credit for Pass-Through Entities. A new provision provides that, the aggregate amount of credit allowed to a pass-through entity in a taxable year for one or more qualified donations, whether made directly or indirectly as owned by another pass-through entity, may not exceed $500,000. Each individual, who is an owner of a pass-through entity, is allowed as a credit an amount equal to the owner's allocated share of the credit to which the pass-through entity is eligible, not to exceed $250,000.

Each corporation, that is an owner of a pass-through entity, is allowed as a credit an amount equal to the owner's allocated share of the credit to which the pass-through entity is eligible, not to exceed $500,000.

If an owner's share of the pass-through entity's credit is limited due to the maximum allowable credit for a taxable year, the pass-through entity and its owners may not reallocate the unused credit among the other owners.

(6) Changes to Partnership Rules. A provision, that formerly stated that the maximum dollar limit in determining the amount of credit applicable to a partnership shall apply separately to each partner, has been deleted.

(7) Effective Date. Ch. 309 (H.B. 463), Laws 2007, is effective for taxable years beginning on or after January 1, 2007.

D. New Audit Focus. The NCDOR believes that many taxpayers are abusing the Conservation Donation Credit and therefore this is a hot audit item. The NCDOR states that it has found that many owners of golf courses and mountain and coastal resorts are abusing the credit by (i) placing easements on property which otherwise cannot (or at least would not) be developed, and (ii) then overvaluing the easement properties.

IX. New Time Limits for Filing Corrected Individual Income Tax Returns After Additional Federal Assessments.

House Bill 1892 has amended several different corporate income tax, individual income tax, and individual gift tax provisions pertaining to the requirement to file amended North Carolina returns to correct for a federal redetermination made after June 30, 2006. Under House Bill 1892, N.C.G.S. 105-130.20 and N.C.G.S. 105-159 have been amended to provide that taxpayers will no longer have two (2) years to file corrected income or gift tax returns after a federal redetermination of the taxpayer's taxable income or net taxable gifts. Now, taxpayers will only have six (6) months to file corrected returns with the NCDOR.

If the taxpayer fails to file amended returns within six (6) months, the taxpayer will forfeit any refunds due by reason of the redetermination. And, also watch out for the "failure to file" penalty!

Note: The new rules apply to federal redeterminations made by the IRS after June 30, 2006.

X. Employment Related Expenses for Determining State Child Care Credit Increased to Federal Amounts.

Under prior law, the North Carolina child care tax credit was based on maximum employment-related expenses of $2,400 for one qualifying dependent and $4,800 for two or more qualifying dependents. S.L. 2006-18 amended G.S. 105-151.11(b) to conform the North Carolina expense amounts to the federal amount of $3,000 for one qualifying dependent and $6,000 for two or more qualifying dependents. This subsection was also amended to clarify that the amount of employment-related expenses for which a credit may be claimed must be reduced by the amount of employer-provided dependent care assistance excluded from the taxpayer's gross income.

(Effective for taxable years beginning on or after January 1, 2006; HB 1892, S.9, S.L. 2006-18.)

XI. No Deduction for Unsubstantiated Charitable Contributions. Secretary of Revenue Decision No. 2006-268, North Carolina Department of Revenue, February 7, 2007. Deductions Claimed for a Taxpayer's Cash and Non-cash Charitable Contributions to a Church Were Disallowed Because the Taxpayer Failed to Provide Adequate Substantiation.

In this case, the Taxpayer timely filed his North Carolina individual income tax returns for the tax years 2002, 2003 and 2004. For the years at issue, Taxpayer claimed the following deductions for charitable contributions on his income tax returns:

Deductions	2002	2003	2004
Cash Contributions	$ 9,500.00	$11,100.00	$11,000.00
Noncash Contributions	$ 3,300.00	$ 3,200.00	$ 2,950.00
Total	$12,800.00	$14,300.00	$13,950.00

The examining auditor requested verification of the charitable contributions for the tax years 2002, 2003 and 2004 from Taxpayer. Because the Taxpayer did not submit factual evidence to verify the contributions, the examining auditor disallowed the contribution deductions for each year.

The Taxpayer contended that he contributed at least thirty percent (30%) of his salary each week to a church, although he was not a member of a church and did not use church envelopes. The Taxpayer also submitted copies of hand written statements showing cash contributions given to a particular church each week for the tax years 2002, 2003 and 2004. The Taxpayer believed that these hand written statements were acceptable documentation.

However, the Taxpayer was unable to provide an acknowledgment from the church for any contributions. Although requested to do so, the Taxpayer did not furnish reasonable or reliable documentation to verify the contributions claimed on his tax returns. So, all of the charitable contribution deductions were disallowed.

XII. New Addition for a Shareholder's Share of an S Corporation's Built-in Gains Tax Deducted by the Shareholder in Determining Federal Taxable Income.

New SL 2006-17 has amended N.C.G.S. G.S. 105-134.6(c) by adding subdivision (3a) which requires a shareholder of an S Corporation to make an addition to federal taxable income for the shareholder's share of built-in gains tax that the S corporation paid for federal income tax purposes. Because the income subject to the built-in gains tax is taxed at both the S corporation and shareholder level for federal income tax purposes, federal law allows the shareholder to deduct his pro rata share of the built-in gains tax to provide relief from federal double taxation. North Carolina does not impose a built-in gains tax upon S corporations. Therefore, there is no double taxation for North Carolina income tax purposes and no reason to allow any deduction for the shareholder's share of the built-in gains tax for North Carolina tax purposes.

(Effective for taxable years beginning on or after January 1, 2006; HB 1898, s.3, S.L. 2006-17.)

XIII. Extension of Use Tax Line on Personal Income Tax Returns.

The 2000 tax year was the first year in which individual taxpayers were allowed to report, on their personal income tax returns, unpaid use tax on out-of-state purchases of use taxed property. We understand that the North Carolina Department of Revenue has collected approximately $5,000,000 of personal use tax and that a substantial portion of these collected amounts are attributable to the new use tax line provided at the bottom of the North Carolina personal individual income tax returns.

Originally, the use tax line was scheduled to be removed beginning with the 2003 tax year. **However, the use tax line will remain on the personal income tax return for the 2005-2009 tax years. The use tax line will be deleted from the income tax return beginning with the 2010 tax returns.**

In addition, as discussed in Part Six of this paper below, the North Carolina Department of Revenue may audit personal income tax returns to determine whether individual taxpayers are complying with their use tax reporting requirements.

XIV. When is a Person a Resident of North Carolina? The Secretary of Revenue issued two decisions in 2003 regarding in-state versus out-of-state residency.

A. Taxpayer Deemed to Adopt North Carolina as His Domicile After Leaving Another State. In the Secretary of Revenue's Decision 2003-220 (August 14, 2003), the taxpayer, who claimed he was not a North Carolina resident, failed to file North Carolina Individual Income Tax Returns for 1995 through 2001. The Department of Revenue took the position that the taxpayer was indeed a North Carolina resident during these periods. Here are the facts:

1. The taxpayer sold his personal residence in another state in February 1994 and began leasing an apartment in North Carolina on March 6, 1994, and had continually leased that property through the date of the Secretary of Revenue Hearing.

2. The taxpayer registered his vehicle with the North Carolina Division of Motor Vehicles on April 18, 1994, and listed his North Carolina address on the registration.

3. In April 1998, the taxpayer surrendered his out-of-state Driver's License and obtained a North Carolina Driver's License.

4. The taxpayer maintained a North Carolina telephone number during the tax years at issue.

5. The taxpayer's out-of-state insurance agent license expired in 1995.

6. Since January 1995, all the taxpayer's mail was sent to his North Carolina address.

7. The taxpayer filed Federal Income Tax Returns for 1995 through 2001 and reflected his North Carolina address on the Federal Tax Returns. However, all the taxpayer's gross income for those tax years was derived from interest income, dividends and capital gains, except for a small amount of wages in 1995 and 1996. Accordingly, all the taxpayer's income was derived from sources <u>outside</u> of North Carolina, even though the federal income tax returns reflected his North Carolina address.

The taxpayer argued that he was the resident of another state during the tax years at issue, and further contended that he had never been employed within North Carolina nor had he ever derived gross income from North Carolina sources attributable to the ownership of any interest in real or tangible property in North Carolina or from a business, trade, profession or occupation carried on inside of North Carolina.

In its brief, the Department of Revenue noted that a "resident" is an individual (1) who is "domiciled" in North Carolina at any time during the year, or (2) who, whether regarding his domicile as inside or outside North Carolina, resides within North Carolina during the year for other than a temporary or transitory purpose. In the absence of convincing proof to the contrary, an individual, who was **present within North Carolina for more than 183 days** during the taxable year, is presumed to be a resident. But, the fact that an individual does not spend more than 183 days within North Carolina raises no presumption that the individual is not a North Carolina resident.

Furthermore, for North Carolina Income Tax purposes, "domicile" is the residence of a person "with the intention to remain there permanently, or for an indefinite length of time, or until some unexpected event shall occur to induce him to leave the same." To effect a change of domicile, a person's first domicile must be abandoned with no intention of returning to it, and actual residence must be established in a new locality coupled with the intention of making that last acquired residence the taxpayer's permanent home. Furthermore, the law presumes that a person's domicile of origin exists until a change of domicile is proved, and the burden of proof is upon the individual alleging the change of domicile.

Of course, domicile is a question of fact and intention, and the determination of domicile does not depend on one fact, but rather on all facts which, taken together, shows the predominance of evidence in favor of a particular place as the domicile.

After reviewing all the facts, the Secretary of Revenue ultimately determined that the taxpayer was indeed a resident of North Carolina during the tax years 1995 through 2001. According to the Secretary, although the taxpayer stated that his intention was never to become a North Carolina resident, this expression of intent alone was not determinative of the issue and, in fact, there were numerous facts which directly contradicted the taxpayer's stated intention that he had not become a resident of North Carolina after 1994. Based upon the numerous contacts between the taxpayer and North Carolina, the Secretary (not surprisingly) determined that the taxpayer had "abandoned" his former domicile and had indeed adopted North Carolina as his new place of domicile.

B. Taxpayers Could Not Establish An Intent To Abandon North Carolina As Their Domicile. In the Secretary of Revenue Decision 2003-318 (November 15, 2003), a husband and wife protested proposed assessments of tax for 2001 and 2002. The following are some of the relevant facts involved in this case:

1. During the periods at issue, the husband worked outside of North Carolina and the wife worked both inside and outside North Carolina during 2002.

2. The taxpayers filed North Carolina Tax Returns for 2001 and 2002 and the 2001 tax return and the residency status indicated on the 2001 tax return indicated that the husband was a part-year resident but the wife was a resident for the entire year. The 2002 return stated that they were both North Carolina residents for the entire year.

3. After the North Carolina Department of Revenue audit began, the taxpayers filed amended North Carolina tax returns for 2001 and 2002. The amended return for 2001 tax year reflected a change of husband's residency from part-year resident to non-resident. The amended return for the 2002 tax year reflected a change in the residency status from a full-year resident to non-resident for husband, and from resident to part-year resident for the wife.

4. In June 2000, the husband accepted an assignment from his employer requiring him to work three days per week outside of North Carolina and two days per week in North Carolina while he maintained his office in North Carolina.

5. In December 2000, the husband accepted a full-time assignment from his employer to another state and began commuting to the other state from North Carolina on a five day per week basis. This assignment ended in July 2001.

6. Effective July 2001, the husband accepted a temporary three-year job assignment in another country from his employer. This assignment ended prematurely in September 2001 and the husband was reassigned to another state. During this time, the husband traveled extensively on business from North Carolina to another state and to another country and would most often return to his wife at home in North Carolina. While temporarily assigned to another country, the employer continued to maintain the husband on the North Carolina payroll of the employer. The husband's employment with the employer ended on March 8, 2002.

7. The husband was employed by an out-of-state business from March 18 through December 2002.

8. The husband rented an apartment in another state on April 18, 2002 and, upon the wife's ceasing employment with her North Carolina employer in June 2002, she joined her husband in the other state.

9. The taxpayers placed their house in North Carolina for sale in June 2002 and moved some of their personal belongings to another state during that month. The North Carolina house was not sold and the taxpayers moved their personal belongings back to North Carolina in January 2003 after husband's employment in another state had ended on December 17, 2002.

10. The taxpayers timely filed their out-of-state Individual Income Tax Returns for 2001 on which they indicated "non-resident" as their residency status.

11. The taxpayers also filed an out-of-state non-resident Individual Tax Return for the 2002 tax year and indicated that they were non-residents of another state the entire year. The return also listed a North Carolina county as the county and state of the taxpayers' residence.

12. Since at least 1986 and throughout the entire periods at issue, the taxpayers owned a residence located in North Carolina. Their Federal Income Tax Returns for the tax year 2001 and their North Carolina Income Tax Returns for 2001 and 2002 reflected that North Carolina address. The taxpayers' out-of-state non-resident Income Tax Returns for 2001 and 2002 reflected the North Carolina address.

13. The husband reported self-employment income on Schedule C of his Federal Income Tax Return for the 2001 tax year for work performed as an accountant. The address reported on the Federal Schedule C reflected the North Carolina address.

14. Withholding reports for the husband's self-employment accounting business were filed by husband for all four quarters during 2001 showing a North Carolina

business address. The reports also listed taxpayer's North Carolina home telephone number. The North Carolina Annual Withholding Reconciliation Report reflected the North Carolina business address.

15. Payments were submitted with the Withholding Tax Reports and payments were made from the husband's business checking account that reflected the North Carolina business address.

16. The husband and wife had been registered to vote in North Carolina since at least October 1978.

17. And finally, the husband and wife had North Carolina Drivers Licenses that were issued by the North Carolina Department of Motor Vehicles in May of 1998.

At the hearing, the husband contended that, because he was employed outside of North Carolina during 2001 and 2002, with temporary job assignments in two other states and in another country, and because he was physically present with temporary living quarters established in each of these various locations, he should not be considered a North Carolina resident during those two tax years. The taxpayers further contend that, because the wife joined the husband at his apartment in California, and was employed there for a portion of the 2002 tax year, she was a part-year resident for that tax year.

As discussed in Section A above, under the North Carolina Administrative Rules, the term "domicile" means the place where an individual has a true, fixed, permanent home and principal establishment, and to which place, whenever absent, the individual has the intent of returning. Section .3901, Subchapter 6B, Title 17 of the North Carolina Administrative Code. A longstanding principle is that an individual can have only one "domicile" and once the domicile is established, it is not legally "abandoned" until a new domicile is established. A taxpayer may have several places of "abode" in a year, but at no time can an individual have more than one domicile. To reflect a change of domicile, there must be an actual act of abandonment of the first domicile, coupled with the taxpayer's intention not to return to it. The question of residency is dependent upon an analysis of all the various facts and circumstances in each case, particularly with respect to whether or not the taxpayer's "domicile" has been abandoned.

Based upon all the facts and circumstances, the Secretary of Revenue determined that, although the taxpayers had established temporary places of abode outside North Carolina, the facts demonstrated that their continued ties to North Carolina indicated a lack of abandonment of their domicile in North Carolina. Accordingly, the Secretary of Revenue determined that the taxpayers had not carried their burden of proving "abandonment" of North Carolina as their state of domicile for the taxable years of 2001 and 2002.

XV. Important Reminder Regarding Reporting Requirements of Buyers of North Carolina Real Property from Non-Residents.

North Carolina taxpayers are reminded that every individual, fiduciary, partnership or corporate buyer of real property located in North Carolina, and sold by a nonresident individual, partnership, estate or trust seller of North Carolina real property must complete Form NC-1099NRS, Report of Sale of Real Property by Nonresidents. The buyer must file the form with the North Carolina Department of Revenue within 15 days of the closing date of the sale, and must furnish a copy of the report to the seller. The form must include (1) the seller's name, address, and Social Security number or federal identification number; (2) the location of the property; (3) the date of closing; and (4) the gross sales price of the real property and its associated tangible personal property. North Carolina Department of Revenue Release (December 10, 2003); Section 3804(c) of Chapter 6B of Title 17 of the North Carolina Administrative Code.

NOTE: No Form 1099 NRS has to be filed when North Carolina real property is purchased from an out-of-state corporation seller.

PART TWO
PROPERTY TAX DEVELOPMENTS

I. Who Is Liable for Delinquent Property Taxes on Real Property Sold During the Tax Year?

A. Background. Under the property tax rules, property must be "listed" during January of each tax year. However, real property taxes do not become delinquent until January 6 of the next tax year.

B. Old Law: Seller is Liable for Delinquent Taxes Not Paid by Buyer. Under prior law, for purposes of determining who is liable for delinquent property tax payments, the "taxpayer" was defined as the owner of the property as of the "listing date." This meant that the seller of real or personal property could be held liable for taxes which the buyer ultimately failed to pay.

As a result, sellers of real estate or personal property had to make sure they collected property taxes due for the year of sale or that they otherwise secured the buyer's agreement to pay the property tax by the normal due date. In the case of the sale and purchase of real or personal property, sellers and buyers have had to carefully "prorate" property taxes for the year of sale.

In the case of real estate sold during the tax year, the seller usually was not too concerned about whether the real estate taxes were ultimately paid by the buyer, since real estate property taxes are a "super priority" lien against the sold real estate. However, in the case of sold personal property, the property tax liability could become a major concern of the seller – in any case where the sold personal property had been moved or otherwise rendered outside the reach of the county tax collector.

C. New 2006 Law Changes: Now, the Buyer Is Directly Liable for Unpaid Real Property Taxes For the Whole Year! Under new S.B. 1451 (effective July 1, 2006), for the purpose of delinquent **real property** tax collection, North Carolina legislation defines "taxpayer" as the owner of record on the date the real property taxes becomes delinquent. This relieves the seller of real property from personal liability if taxes become delinquent after the sale. Now, the buyer of real property will bear responsibility for payment of all real property taxes during the year of sale. As a result, buyers (and no longer sellers) will be primarily concerned about proper prorations of real property taxes for the year of sale.

Additionally, the legislation requires that the taxing unit send notice of a tax lien on property to the record owner as of the date the property taxes become delinquent. This advertisement must also state the names of the record owner and any subsequent owner instead of the listing owner. Further, the legislation also authorizes the taxing unit to enforce the remedy of attachment and garnishment against the record owner of property as of the date the taxes on the property became due instead of the listing owner.

Note: No Change to Rules Applicable to Delinquent Personal Property Taxes. The new rules do not alter the definition of "taxpayer" for **personal property** tax purposes. So, with respect to delinquent personal property taxes, the old rules remain - the seller of personal property can be held liable for taxes which the buyer ultimately fails to pay - which can be a major concern of the seller in any case where the sold personal property had been moved or otherwise rendered outside the reach of the county tax collector. So, Sellers still must take steps to make sure the buyer ultimately pays the personal property taxes for the year of sale.

II. 2006 House Bill 1465 Now Extends "Farm Land" Property Tax Qualification to Owners Who Lease Farm Land.

A. Introduction. As we all know, N.C.G.S. 105-277.2 allows for a reduced property tax rate for family-owned farm land. Under the prior version of N.C.G.S. 105-277.2(4)(b), if a family business entity (such as a partnership or LLC) owned the farm land, the family business had to actually be engaged in the farming business to be eligible for the reduced farm property tax rates.

B. New Legislative Amendments. House Bill 1465 has amended N.C.G.S. 105-277.2(4)(b) to allow farm land owned by a family business, to keep its present-use tax value status where the property is leased for farm use, as long as all of the members of the business entity are relatives. This new provision is effective for taxable years beginning on or after July 1, 2004.

III. County Board of Equalization May Now Consider Late "Present Use" Value Applications.

A. Background. Agricultural land, horticultural land, and forestland are eligible for taxation on the basis of the value of the property in its "present use" if a timely and proper application is filed with the county assessor. N.C.G.S. §105-277.4(a). "Present-use value" of land in its current use as agricultural land, horticultural land, or forestland, is based solely on its ability to produce income, using a rate of 9% to capitalize the expected net income of the property and assuming an average level of management. N.C.G.S. §105-277.2(5).

B. Prior Law: "Present Use Value" Application and Due Dates for Pre-2007 Tax Years. A taxpayer must file a timely and proper application with the county assessor of the county in which the property is located. The application must clearly show that the property comes within one of the classes and contain any other relevant information required by the assessor to make a proper appraisal of the property at its present-use value.

An "initial application" must be filed **<u>during the regular listing period</u>** of the year for which the benefit is first claimed or within 30 days of the date shown on a notice of a change in valuation. A new application is not required unless the property is transferred or becomes ineligible for use-value appraisal because of a change in use or acreage. [G.S. §105-277.4(a)]. An application required due to transfer of the land must be submitted within 60 days of the date of the property's transfer [G.S. §105-277, 4(a), as added by S.B. 1161, §3, effective for taxable years beginning on or after July 1, 2003].

C. <u>Under 2006 Law, Board of Equalization May Review Late "Present Use Value" Application</u>. New S.L. 2006-30 adds new subsection N.C.G.S. 105-277.4 (a1) which allows an applicant for present-use value classification to file an untimely application, where previously no such provision existed. The untimely application applies only to property taxes levied by the county or municipality in the calendar year in which the untimely application is filed. The applicant must show **good cause** for failure to file timely, and the untimely application <u>may</u> be approved by the board of equalization and review or, if that board is not in session, by the county commissioners.

(Effective June 29, 2006; HB 2097, S.L. 2006-30 s.4.)

PART THREE
ESTATE AND GIFT TAX DEVELOPMENTS

I. No Repeal of North Carolina Gift Taxes Seems To Be On The Horizon.

The following are the only states that have independent gift tax systems: Connecticut, Louisiana, Tennessee and North Carolina.

As we all know, North Carolina repealed the North Carolina inheritance tax and replaced it with an estate tax which is now equal in amount to the full amount of the applicable federal state death tax credit. However, the legislature has not repealed the North Carolina gift tax.

North Carolina still retains the "Class Donee" system for calculating North Carolina gift tax. The amount of the gift tax is imposed at different tax rates depending upon whether the donee is a Class A, B or C donee. In addition, a $100,000 lifetime specific exemption amount is allowed to decrease the net taxable amount of gifts to Class A donees. However, only parents and lineal issue are eligible Class A donees.

Obviously, there is no logic to the fact that North Carolina has retained its gift tax, but yet repealed the North Carolina inheritance tax. Nevertheless, budgetary concerns have caused the legislature to indefinitely postpone any consideration to the repeal of the gift tax, in light of the legislature's estimations that repeal of the gift tax would cause a loss of revenue of approximately $20,000,000 per year if the North Carolina gift tax was repealed. Given the current budget constraints of the State of North Carolina, it is extremely doubtful that we will see a meaningful discussion of the repeal of the North Carolina gift tax in the foreseeable future.

In light of the fact that federal gift tax and estate tax exemptions are scheduled to gradually increase over the next several years (with full repeal of the federal estate tax, but not the gift tax, after the year 2009), we need to remind our clients that the North Carolina gift tax can be an expensive cost of poor transfer tax planning.

II. Gift Tax: Temporary Transfer to Avoid Creditors Was Subject to Tax.

The conveyance of property to a family member during the taxpayer's divorce proceedings was subject to North Carolina gift tax because the property was transferred in fee simple by a written deed. The oral agreement between the parties, prior to the transfer, stating that the property would be conveyed back to the taxpayer-transferor immediately after the conclusion of the divorce proceeding was irrelevant. The deed was considered the final agreement of the parties and it did not establish that the former owner maintained practical ownership of the property throughout the transfer by reserving the right to recover the property to himself. (Joines v. Anderson, North Carolina Court of Appeals, No. COA02-179, November 18, 2003).

III. Gift to Daughter-in-Law Taxed as Class C Donee Gift.

In Secretary of Revenue Decision 2003-381 (January 30, 2004), the donor transferred three parcels of real property to his son and daughter-in-law. Although the donor and son asserted that the donor's gift was intended to solely benefit the donor's son, the Secretary of Revenue concluded that gift tax was properly assessed on the portion of the gift to the daughter-in-law, as a Class C donee. Also, since one-half of the gift was to a Class C donee, the portion of the gift to the daughter-in-law did not qualify fo the $100,000 specific gift tax exemption.

> **NOTE:** Since the son and daughter-in-law were spouses, the gift created a tenancy-by-the-entirety, which meant that the value of the gift would be equally divided between the son and daughter-in-law. Should the value of the gift to the daughter-in-law be subject to a "fractional interest" valuation discount?

IV. Transfer of Real Property Subject to a Reserved Special Power of Appointment Deemed to Be a Taxable Gift for North Carolina Gift Tax Purposes.

A. Background of Federal Gift Tax Rules Pertaining to Reserved or Retained Special Powers of Appointment. Under the federal gift tax system, if a donor transfers property, but retains a power of appointment over the transferred assets (such that the timing of the gift or identity of the donee will not be determined until a later point in time), the gift will not be complete until the donor exercises the power of appointment or the power of appointment otherwise lapses.

> **Example**: Father owns real property and is concerned about possible creditor claims. Father transfers the real estate, by deed, to his Son and Daughter. However, in the deed, Father retains the power to appoint the real property to any of his other children or grandchildren at any time during his lifetime (i.e., thus reserving a special power of appointment over the gifted real property).

In this case, for federal transfer tax purposes, the transfer is not deemed to be complete until Father's death or until Father exercises the reserved special power of appointment in favor of one or more of his children. Since the gift is not complete, there will be no federal gift tax due upon the gift. If Father exercises his power of appointment during his lifetime, then federal gift tax will be due at that time (subject to the $1 Million lifetime gifting exemption).

If Father dies without having exercised the reserved power of appointment, then the real property will be included in Father's gross taxable estate for federal estate tax purposes. The real estate will be included in Father's taxable estate under IRC §2036 because the father transferred the property, but retained the power to determine who ultimately would enjoy ownership of the property. At that time, at Father's death, if Father's gross taxable estate exceeds the estate tax exemption amount, then Father's estate would be subject to federal estate tax (and North Carolina estate tax) on the value of the real property at that time. However, the value of Father's gross taxable estate does not exceed $2 Million, then there will be no federal or North Carolina estate tax due in that event when the real property passes to Son and Daughter.

Things can get even better for Son and Daughter. Since the real property is "brought back" into Father's federal taxable estate for federal estate tax purposes, his heirs (Son and Daughter) will receive an income tax basis step-up equal to the fair market value of the real property as of the date of Father's death - even if there is no federal estate tax due at Father's death. IRC Section 1014.

So, Father is able to accomplish a great result here. First of all, Father is able to transfer legal ownership of the property to Son and Daughter (and perhaps avoid creditors' claims in the meantime), but there is no current federal gift tax owed on the transfer! And, Son and Daughter also get an income tax basis step-up for the property at Father's death!

B. <u>North Carolina Department of Revenue Takes a Contrary Position That Gifts, Even with Retained Special Powers of Appointment, Are Nevertheless Complete for North Carolina Gift Tax Purposes. Secretary of Revenue Decision 2005-234 (October 9, 2006)</u>. Unfortunately, the North Carolina Department of Revenue takes the position that gifts, even with retained special powers of appointment, are nevertheless complete for North Carolina gift tax purposes. In Secretary of Revenue Decision 2005-234 (October 9, 2006), Mother deeded a 99% interest in six parcels of real estate by a North Carolina real property deed. However, Mother held back a "reserved special power of appointment," which provided that the Mother reserved the power to appoint, in whole or in part, the transferred interest to or for the benefit of any one or more of the issue of the taxpayers' parents - other than the taxpayer.

The taxpayer took the position that there was no taxable gift since the donor retained a special reserved power of appointment and therefore the gift should be deemed to be incomplete for federal and North Carolina gift tax purposes. However, the Department of Revenue cited N.C.G.S. 105-195 which states that:

> when property is transferred or otherwise limited and the rights or interests of the transferees or beneficiaries are dependent upon contingencies or conditions whereby they may be wholly or in part created, defeated, or abridged, a tax shall be imposed upon said transfer at the highest rate, within the discretion of the Secretary of Revenue which, on the happening of any of the said contingencies or conditions would be possible.

In this case, the donor reserved a power to ultimately transfer the property to any issue of the taxpayers' parents, which the donor could exercise at any time. Therefore, based upon the language of N.C.G.S. 105-195, which states that the NC Department of Revenue can assess tax at the highest rate based upon the happening of any contingencies under the reserved special power of appointment, the Secretary of Revenue held that the transfer should be subject to immediate gift taxation.

Also, since the potential takers would include the donor's brother or sister (Class B beneficiaries), the Secretary of Revenue determined that the Department of Revenue could assess tax on the entire transfer **at the Class B gift tax rates**. According to the Secretary of Revenue, because it was possible that the donor could have immediately exercised the "reserved special powers of appointment" in favor of the donor's sibling (a Class B donee), the DOR was ***obligated*** to assess tax at the higher Class B tax rate on the entire transfer.

Note: Since this was a deemed transfer to a Class B beneficiary, the gift was **not** sheltered by the $100,000 lifetime specific exemption which is available only to offset gifts to Class A donees.

V. North Carolina Tax Law Conforms (Somewhat) with EGTRRA.

A. Introduction. The federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), signed by President Bush on June 7, 2001, made significant changes to the estate tax provisions of the Internal Revenue Code. The changes (1) increased the amount excluded from federal estate tax and (2) phased out the state death tax credit.

The following chart reflects the federal death tax exemptions:

Year of Death	Federal Exemption Amount
2001	$ 700,000
2002 - 2003	$1,000,000
2004 - 2005	$1,500,000
2006 - 2008	$2,000,000
2009	$3,500,000
2010	N/A
2011	$1,000,000

The following chart reflects the available federal estate tax credit for state death taxes paid:

Year of Death	Federal State Death Tax Credit
2001	100% of present credit
2002	75% of present credit
2003	50% of present credit
2004	25% of present credit
2005	Credit replaced by a federal estate tax deduction

The changes began to take effect for decedents dying on or after January 1, 2002.

B. North Carolina Only Partially Conforms with Federal Estate Tax Law. EGTRRA changed federal law on these matters, but it did not change North Carolina law. We have hoped that the North Carolina Legislature would adopt conforming changes to EGTRRA.

However, under Session Law 2005-144 (House Bill 1630) (June 30, 2005) and Session Law 2005-276 (August 13, 2005), North Carolina will not conform to Federal EGTRRA.

Thus, North Carolina's estate tax law is still tied to the Internal Revenue Code as it exists on a certain date. That date is set in G.S. 105-32.1(1) and G.S. 105-228.90(b)(1b), and the date is **currently January 1, 2001**. This means that a decedent dying after January 2004 with an estate of less than $1.5 Million will not owe any North Carolina estate tax. Likewise, the estate of a decedent dying after January 1, 2006 with an estate less than $2 Million will not owe any North Carolina death tax.

NOTE: The North Carolina Estate Tax Return, Form A-101, has been revised to reflect partial North Carolina state conformity with EGTRRA. This new Form A-101 was revised in September 2005.

Unfortunately, however, North Carolina has not adopted conforming changes relating to the phase-out of the federal state death tax credit. This means that estates of decedents dying in 2005 or 2006 with estates over $1.5 Million and $2 Million will pay North Carolina estate tax equal to **100%** of the federal state death tax credit that would have applied to the estate based upon the normal federal estate death tax credit formula in effect as of 2001. This means that the North Carolina estate tax is equal to the state death credit for federal tax purposes before applying the percentage reduction to the federal credit.

NOTE: Until the General Assembly further changes the law, the amount of North Carolina estate tax imposed under North Carolina law will continue to be the **maximum credit for state death taxes** allowed under section 2011 of the Code **as of January 1, 2001**. This means that it may be **less costly** to die a resident of another state which limits the state death tax to the amount of the federal state death tax credit that is actually allowable for federal estate tax purposes for the year of death.

C. **Conformity With North Carolina Gift Tax Law - Increase in Annual Gift Tax Exclusion.** North Carolina has an independent gift tax system. However, as a result of conformity changes with the federal tax system, the North Carolina annual gift tax exclusion is now $12,000 per donee per year.

If North Carolina elects to conform to EGTRRA, the North Carolina Department of Revenue will begin losing substantial revenue beginning as the result of the phase-out of this federal estate death tax credit. Will this development and ongoing budgetary concerns force the North Carolina legislature to consider reinstating the North Carolina inheritance tax?

VI. New Due Dates for Filing An Amended North Carolina Death Tax Return After Federal Redetermination.

Under House Bill 1892 (enacted June 2006), N.C.G.S. §105-32.8 has been revised to now provide that, if the IRS corrects or otherwise determines a gross estate tax owed to the IRS or the amount of the maximum state death tax credit allowed to an estate, the personal representative ("PR") of the estate must file a corrected North Carolina tax return within six (6) months after the federal redetermination. The new rules will now place a six (6) month time limit upon which an amended North Carolina return must be filed. Previously, the personal representative ("PR") was given two (2) years to file an amended return.

Moreover, the new amendments to N.C.G.S. 105-32.8 also provide that if a PR fails to report a federal correction on a timely basis, then the PR forfeits any refund otherwise due from the North Carolina Department of Revenue by virtue of the redetermination. Also, watch out for the "late filing" penalty!

Note: The new rules apply to federal redeterminations made by the IRS after June 30, 2006.

VII. New Due Dates for Filing An Amended North Carolina Gift Tax Return After Federal Redetermination.

House Bill 1892 has amended the individual gift tax provisions pertaining to the requirement to file amended North Carolina returns to correct for a federal redetermination made after June 30, 2006. Under House Bill 1892, N.C.G.S. 105-130.20 and N.C.G.S. 105-159 have been amended to provide that taxpayers will no longer have two (2) years to file corrected gift tax returns after a federal redetermination of the taxpayer's taxable income or net taxable gifts. Now, taxpayers will only have six (6) months to file corrected returns with the NCDOR. If the taxpayer fails to file amended returns within six (6) months, the taxpayer will forfeit any refunds due by reason of the redetermination.

Note: The new rules apply to federal redeterminations made by the IRS after June 30, 2006.

PART FOUR
NORTH CAROLINA SALES AND USE TAX DEVELOPMENTS

I. 2006 Changes: North Carolina Sales and Use Tax Rate Reduced After December 2006.

SB 1741 (effective July 1, 2006) accelerated the repeal of the temporary increase in the sales and use tax rate. Thus, the North Carolina general sales and use tax rate was lowered from 4.5% to 4.25% applicable to sales made on or after December 1, 2006. In addition, the North Carolina general sales and use tax rate was scheduled to be lowered further to 4% for sales made on or after July 1, 2007.

II. 2007 Changes to Sales Tax Rates and Retailer's Liability Regarding State Rate.

The 2007 budget permanently extended the additional 0.25% portion of the state sales and use tax rate (which was scheduled to expire on August 1, 2007), that results in a general state tax rate of 4.25%. Effective October 1, 2008, and applicable to sales occurring on or after that date, the general state sales and use tax rate is increased from 4.25% to 4.5%. Effective October 1, 2009, and applicable to sales occurring on or after that date, the general state sales and use tax rate is increased from 4.5% to 4.75%. These two rate hikes are enacted within the context of the state's assumption of certain Medicaid responsibilities

The corrections bill specifies that a retailer, that has over-or-under-collected sales tax because of the rate change, is not liable for that over-or-under-collection - provided the retailer has made a good faith effort to comply with the law and collect the proper amount of tax. **This provision is effective August 6, 2007, and is applicable only to the period beginning August 1, 2007, and ending September 1, 2007.**

Ch. 345 (H.B. 714), Laws 2007.

III. New Streamlined Sales Tax Exemption Certificate Form for North Carolina Sales & Use Tax Purposes: North Carolina Department of Revenue Directive SD-04-1 (June 2004).

The North Carolina Department of Revenue has issued a new Directive which explains procedures that became effective January 1, 2005, for providing exemption certificates to vendors when the taxpayer makes purchases of tangible personal property that are (1) exempt from sales or use tax or (2) subject to a preferential rate of tax. A new exemption certificate (Form E-595E, Streamlined Sales Tax Agreement Certificate of Exemption) is to be used for (1) purchases for resale or (2) other exempt purchases as set forth in the Directive.

Under the new Directive, the following forms have been discontinued and should no longer be accepted by a vendor:

Form E-526	Logging or Pulp Wood Certificate
Form E-558	Commercial Fisherman Certificate
Form E-567	Veterinarian Certificate
Form E-575	Manufacturer's Certificate
Form E-580	Contractor's and Subcontractor's Certificate
Form E-590	Certificate of Resale
Form E-599	Agricultural Certificate
Form E-599Y	Ice Certificate

A. Background. Under N.C.G.S. 105-164.28(a), a seller who accepts a Certificate of Resale from a purchaser has the burden of proving that the sale was not a retail sale, unless all of the following conditions are met:

1. For a sale made in person (over the counter), the certificate is signed by the purchaser, states the purchaser's name, address and registration number, and describes the type of tangible personal property generally sold by the purchaser in the ordinary course of business;

2. For a sale made in person where the purchaser is engaged in the business of selling tangible personal property of the type sold; and

3. For a sale made over the internet or other remote means (remote sale) the sales tax registration given by the purchaser matches the number on the Department's registry.

In addition, under N.C.G.S. 105-164.28(b), if a purchaser uses (rather than resells) property purchased under a Certificate of Resale, the purchaser is liable for any tax determined to be due on the sale. However, the retail seller of property sold under a Certificate of Resale will be **jointly liable** with the purchaser for any unpaid sales tax if the Secretary proves that the sale was a retail sale.

Finally, under N.C.G.S. 105-164.28A, a purchaser who is exempt from tax or is subject to a preferential tax rate may present an exemption certificate to the seller. Such an exemption certificate authorizes the retailer to sell the tangible property to the certificate holder and either collect tax at the preferential rate or not collect tax on the sale as appropriate.

B. **New Exemption Certificates for Sales for Resale.** Effective January 1, 2005, a purchaser of property for resale should issue the new Form E-595E to a vendor in order to exclude the sale from sales or use tax. A vendor who has accepted a Form E-590 from a purchaser prior to January 1, 2005, is not required to obtain a new Form E-595E. The purchaser's sales and use tax registration number and any other information required under N.C.G.S. 105-164.28 must be entered on the certificate.

C. **Sales to Manufacturers.** A manufacturer should issue Form E-595E to a vendor when making a purchase of property subject to the preferential one percent (1%) state rate of tax or property that is exempt from tax, such as ingredient or component materials or packaging materials that become part of the sale of a product.

D. **Sales to Farmers, Commercial Fishermen, Loggers and Veterinarians.** Now, these purchasers **also must** issue a Form E-595E to a vendor as authority for collecting the reduced rate of tax or no tax. **In addition, these taxpayers now also must obtain an exemption number from the North Carolina Department of Revenue to claim any sales and use tax exemption.**

E. **Seller Liability.**

1. **Liability for Over-the-Counter Sales.** When a customer makes a qualifying purchase as indicated on the exemption certificate and furnishes a properly completed certificate to a vendor, the vendor is relieved of the liability for any additional tax that is subsequently determined to be due, and the purchaser has assumed liability for the tax. In the absence of proper documentation to support a full or partial exemption from tax, the vendor will be held liable for any additional tax determined to be due. A purchaser making occasional or infrequent purchases of tangible personal property that is eligible for an exemption should furnish a copy of this certificate with each purchase order. A purchaser who makes frequent purchases of the same type property from a vendor is only required to issue a single certificate to that vendor. A copy of a completed certificate should not be sent to the Department of Revenue unless requested by the Department.

2. **Liability for Remote Sales.** For a sale for resale, a vendor is relieved of liability for any additional tax that is subsequently determined to be due when the vendor secures a sales and use tax registration number for a purchaser that matches the number on the Department's registry in lieu of obtaining a completed certificate. For a sale subject to a preferential rate of tax or exempt from tax other than as a sale for resale, the liability is relieved when the vendor secures the information as to a purchaser's type of business, reason for exemption, and identification number in lieu of obtaining an exemption certificate. The registry of sales and use tax registration numbers and a registry of exemption numbers is available on the Department's website at www.dor.state.nc.us. A vendor may choose to review the appropriate registry subsequent to the completion of a sale.

F. **Observation.** As discussed above, under N.C.G.S. 105-164.28, even if a seller sells property to a purchaser under a Certificate of Resale, the seller can still be jointly liable with the purchaser for any unpaid tax where the Secretary proves that the sale to the purchaser/ certificate-holder was a retail sale. In essence, N.C.G.S. 105-164.28 warns that, even if a seller accepts a Certificate of Resale, the seller can still be jointly liable with the purchaser for any unpaid sales tax if the Department of Revenue determines that the sale was a "retail sale."

Thus, the new Department of Revenue directive effectively eliminates the potential liability of the seller under N.C.G.S. 105-164 where a properly documented Form E-595E is provided to the seller as long as (1) other appropriate documentation is provided by the purchaser/certificate-holder to the seller (including the purchaser's exemption number) and (2) the Seller can confirm that items listed in the Exemption Certificate indeed are exempt from sales tax assessment.

IV. New Privilege Tax Replaces the Former 1% Use Tax on Sales of Mill Machinery.

Before January 1, 2006, the 1% sales tax applied on the purchase of mill machinery or mill machinery parts and accessories by manufacturing industries and plants, and by contractors and subcontractors for use in the performance of a contract with a manufacturing industry or plant.

Effective January 1, 2006, North Carolina has repealed the 1% sales tax for mill machinery under NCGS 105-164.4 in order to conform the North Carolina sales tax laws with the Streamlined Sales Tax Project. Now, purchasers of mill machinery equipment by manufacturers and their contractors must pay a 1% privilege tax on these purchases (subject to a maximum tax of $80 per article), and these items are fully exempted from the sales and use tax. These buyers of mill machinery and equipment must pay a 1% privilege tax by filing a Form E-500J on a monthly basis, which means that these purchasers of mill machinery will in essence pay a use tax on purchased mill machinery.

Note: Please note that the new privilege tax also applies to contractors or subcontractors who perform a construction contract with a general contract or that has a contract with a manufacturing industry or plant.

Note: Sellers of mill machinery will no longer be responsible or liable for collecting the sales tax or mill machinery items.

You can find the new rules at NCGS 105-187.50 through NCGS 105-187.52. North Carolina Department of Revenue Directive SD-05-1 dated October 12, 2005.

V. New Research and Development Privilege Tax Replaces Sales and Use Tax.

Note: The following is reproduced from CCH, State Tax Review, Dated July 18, 2006.

Effective July 1, 2007, a 1% privilege tax is imposed (up to a maximum tax or $80.00 per article) on the sales price of equipment or other tangible personal property purchased by a "research and development" company (1) engaged in the fields of physical, engineering and life sciences that is included in Industry Section 54171 of the NAICS and (2) that purchases equipment or an attachment or repair part for equipment that:

(i) is capitalized by the taxpayer Company for income tax purposes;

(ii) is used by the taxpayer Company in the research and development of tangible personal property;

(iii) would be considered normal mill machinery if it were purchased by a manufacturing industry or plant and used in the R&D of tangible personal property manufactured by the industry or plant.

The industries covered by industry 54171 of the NAICS include research and development businesses in the fields of physical, engineering and life sciences, such as biotech and pharmaceutical R & D companies.

Note: The legislative purpose of the new R&D privilege tax is to benefit R&D companies that do not manufacture anything. Indeed, there are many North Carolina companies that do not produce any "product," but that nevertheless produce ideas, formulas and processes which then will be sold to actual product manufacturers. Prior to the new laws, these R&D companies would not have been eligible for the benefits of the "mill machinery" tax provisions, because they are not actually engaged in "manufacturing." So, the new rules will benefit many pharmaceutical and biotech and other technology companies who purchase machinery, parts and accessories (such as computers and testing equipment) they use in R&D development.

Note: The new 1% privilege tax will not be effective until July 1, 2007. Senate Bill 1741, as amended by H.B. 1891 (August 3, 2006).

Query: What does "capitalize" mean? Does this mean that equipment subject to the Section 179 deductions aren't eligible for the new 1% privilege tax? Presumably, the new privilege tax benefits are not intended to disqualify property subject to the Section 179 deduction. Instead, the "capitalize" requirement is presumably intended merely to eliminate normal supplies and other consumables from the 1% privilege tax.

VI. **Funeral Services Now Completely Exempt From Sales Tax**

Under new 2006 tax law, the existing sales tax exemption for funeral expenses not to exceed $1,500.00 was repealed. The effect of this change is that funeral services are no longer subject to the sales or use tax. However, any tangible personal property, such as caskets or vaults, sold in connection with funeral services are subject to the general State rate and applicable local rate of tax.

(Effective January 1, 2006; SB 622, s. 33.9, S.L. 05-276.)

VII. **New Sales And Use Tax Breaks for Professional Motorsports Racing Teams**.

Under Senate 1741, effective for purchases made on or after July 1, 2007, a "professional motorsports racing team" will be allowed a refund of 50% of the sales and use tax paid on tangible personal property (other than tires or "accessories") that comprises any part of a professional motor racing **vehicle**. "Accessories," not eligible for the refund, include instrumentation, telemetry, consumables and paint. Thus, these vehicle "accessories" are not eligible for the 50% sales and use tax refund.

A "professional motorsports racing team" is a racing team that:

(i) is operated for profit;
(ii) derives a majority of its revenue from sponsorship of the team and prize money; and
(iii) competes in at least 66% of the races sponsored in a single season by a motorsports sanctioning body.

A request for refund must be made in writing and must be filed within six (6) months after the end of the state's fiscal year which ends on June 30 of each year. No refund application will be considered if it is not filed within the six (6) month refund application period. So, a refund request for the fiscal year ending June 30 must be filed by December 30.

> **Note:** Also, N.C.G.S. 105-164.14 also allows for a refund for sales and use tax paid on **aviation fuel** used to travel to and from motorsports events. This provision was set to expire for purchases made on or after January 1, 2007, but now has been extended for two years. The aviation fuel refund now is scheduled to be repealed for purchases made on or after January 1, 2009.

VIII. **S&U Tax: Deduction for Bad Debts Clarified.**

Accounts of purchasers representing taxable sales on which North Carolina sales and use tax has been paid that are found to be worthless and that are charged off for income tax purposes may be deducted from gross retail sales as worthless accounts or bad debts. The amount of any deduction taken for bad debts cannot include accrued interest. If a deduction is taken for a bad debt that is subsequently collected in whole or in part, the tax on the amount collected must be reported and paid on the return for the period in which the collection occurs.

A taxpayer must claim the deduction for a bad debt **within three years** of charging of the debt for income tax purposes. A taxpayer that is not required to file income tax returns may deduct a bad debt that would otherwise have been eligible to be charged off for income tax purposes and must claim the deduction within three years of the date the account is recognized and expensed as a bad debt on the taxpayer's books and records. When the amount of the bad debt deduction exceeds the amount of tax due on the return, the taxpayer may file a refund claim within three years of the date the bad debt became eligible for deduction. (Directive No. SD-03-2, North Carolina Department of Revenue, October 15, 2003).

IX. Secretary of Revenue Decision No. 2006-145, North Carolina Department of Revenue, November 7, 2006 (Released February 13, 2007). A Manager of a Limited Liability Company Was Personally Liable for the Unpaid North Carolina Sales Taxes of the LLC.

Under N.C.G.S. 105-253(b), the North Carolina Department of Revenue is authorized to assess a "responsible officer" for unpaid sales taxes of a corporation or an LLC. The term "responsible officer" is defined to include the manager of an LLC. Moreover, it is irrelevant to the determination of liability whether the manager had the authority to collect and/or remit the tax; managers are considered responsible officers and may be held personally liable.

In this case, the LLC made retail sales of clothing during the period covered by the assessments. The LLC collected the sales tax on its retail sales of clothing but failed to remit the sales tax to the Department. The LLC closed its business in August 2002.

The Taxpayer was a manager of the LLC and was responsible for the purchasing and merchandising of the products for the stores and developing the store locations. The Taxpayer was assessed the sales tax as a "responsible officer" after the LLC failed to pay the Department the sales taxes it had collected.

In this case, the Taxpayer was the only person listed under the section for "Corporate Officers" on the sales and use tax registration application and listed his title as managing member.

Also, the Articles of Organization for the LLC listed the Taxpayer as one of the "Organizers" of the LLC. Also, Article VIII, Managers, Section 8.2(b) of the Operating Agreement for the LLC, provided that the Taxpayer was appointed one of the managers of the

LLC and by signing the agreement, he accepted the appointment. Also, the Taxpayer was listed as the registered agent of the LLC on the Secretary of State's website.

Conclusions of Law

Based on the foregoing findings of fact, the Assistant Secretary made the following conclusions of law:

G.S. 105-253(b) provides that each responsible officer of a limited liability company is personally and individually liable for all sales taxes collected by the limited liability company. The term "responsible officer" is defined to include "the manager" of a limited liability company. The Taxpayer therefore was a responsible officer, and as such was liable for the North Carolina and applicable county sales taxes collected by the LLC, but never remitted to the Department of Revenue.

G.S. 105-253(b) authorizes the Department to assess a responsible officer for the unpaid sales taxes of a corporation or a limited liability company. The term "responsible officer" is defined to include the manager of a limited liability company. Even though the Taxpayer stated he was not responsible for collecting and remitting the sales taxes, there was no doubt that this Taxpayer was a manager and therefore was a responsible officer of the LLC. The Taxpayer was the only officer listed on the sales and use tax registration application and his title was listed as Managing Member. He signed the LLC's Operating Agreement, acknowledging his appointment as manager. Finally, the Taxpayer signed the LLC's annual reports as Managing Member, and the LLC's tax returns as Managing Partner.

X. Corporate Officer of Selling Corporation Held Liable for Unpaid Sales and Use Tax Despite the Sale of the Corporation's Assets to an Outside Third Party; Secretary of Revenue Decision 2004-359 (October 28, 2005).

In the case of Secretary of Revenue Decision 2004-359 (decided March 7, 2005 and released October 28, 2005), the taxpayer was the president of a corporation which had delinquent sales tax returns which were **filed** by the taxpayer on **July 6, 2001**. At that time, the taxpayer notified the Department of Revenue when he filed the delinquent returns that he had **sold** the business on **June 17, 2001**.

The taxpayer tried to claim that the purchaser should have taken steps to make sure that any delinquent sales taxes had been paid at the time that the business was sold to the purchaser. In this case, the taxpayer corporate officer made a clever argument that, since N.C.G.S. 105-164.38 provides that unpaid sales and use taxes are liens against assets of the sold business, any purchaser should withhold a portion of the purchase price to make sure that unpaid sales taxes are brought current.

In fact, under N.C.G.S. 105-164.38(a), unpaid sales and use taxes are liens on all personal property of any person engaged in business and who stops in engaging in business by selling a business or its assets or by going out of business. N.C.G.S. 105-164.38(a). A person who stops engaging in business must file the sales and use tax returns within thirty (30) days after selling the business and/or its assets or after going out of business. N.C.G.S. 105-164.38(a).

The taxpayer argued that, under N.C.G.S. 105-164.38(b), the purchaser of the business should have withheld, from the consideration paid, an amount sufficient to cover the corporation's sales tax liabilities. In essence, the taxpayer claimed that, under N.C.G.S. 105-164.38(b), it was the purchaser's responsibility to make sure that the seller's outstanding sales tax liabilities had been satisfied at the time of sale.

However, that statute (N.C.G.S. 105-164.38(b)) also states that the buyer must withhold part of the purchase price for the payment of the seller's sales tax liabilities, <u>until</u> the seller provides the buyer with a certificate from the NCDOR confirming that the seller's sales tax liabilities have been paid. N.C.G.S. 105-164.38(b). Of course, in this case, the NCDOR could not have issued such a statement to the taxpayer-seller or to the purchaser because, at the time of the sale, the reports and the sales tax for the periods in question had not been filed or paid.

Therefore, according to the Secretary of Revenue, the NCDOR is not prevented from assessing, against the seller of the business, unpaid sales taxes.

Next, the Secretary of Revenue determined that the taxpayer, as an officer of the seller, should be held **personally liable** for the unpaid sales taxes. Under N.C.G.S. 105-253(b), certain corporate officers of the seller may be personally liable for unpaid sale taxes. N.C.G.S. 105-253(b). Under N.C.G.S. 105-253(b), a corporate officer can be a responsible party who is personally liable for (i) unpaid sales and use taxes and (2) income taxes withheld from employee wages. Each responsible officer of any corporation that is required to file sales and use tax returns is personally liable for payment of the tax owed by the corporation. Generally, the term "responsible officer" means the president **and** the treasurer of the corporation. N.C.G.S. 105-253(b).

> **Note**: <u>Purchasers Are Also Liable for Unpaid Sales and Use Taxes of Seller</u>. The Secretary of Revenue also is authorized to hold a purchaser of the business (or its assets) liable for the seller-business's unpaid sales taxes because unpaid sales and use taxes are liens upon all personal property of a sold business or of a business that goes out of business, **even if there is no filed tax lien of record**. N.C.G.S. 105-164.38(b). Under N.C.G.S. 105-164.38(b), if the purchaser fails to withhold an amount sufficient to cover the seller's taxes, and the seller's taxes still remain unpaid after 30 days, the **buyer** is personally liable for the unpaid taxes to the extent of the <u>greater</u> of:
>
> (i) the consideration paid by the buyer, or

(ii) the fair market value of the business or stock of goods.

Conclusion. This case is important in that it reminds us of (1) the **potential officer responsibility** for unpaid sales taxes **and** (2) that unpaid sales taxes are a ***de facto*** lien against sold assets. Thus, where unpaid taxes remain after a business is sold or where the business ceases to exist, the Department of Revenue may proceed against the Seller or against the Seller's responsible corporate officers **or** it may proceed with collection actions against the purchaser.

XI. Sale of Property in North Carolina To An Out-of-State Buyer Are Subject to North Carolina Sales Tax - Even Where The Buyer Contracts With Its Agent To Transfer And Install The Property Out-of-State. Secretary of Revenue Decision 2005-145 (October 28, 2005) (CCH 202-331).

In this case, the taxpayer was a North Carolina corporation that sold furniture, draperies, fabric and other tangible personal property.

An out-of-state purchaser bought merchandise from the taxpayer in a North Carolina sale. The taxpayer and purchaser agreed that part of the purchase price would not be paid until delivery was made in the buyer's home state.

The purchaser contracted with an independent installer (the "Installer") to transport and install the tangible personal property in the buyer's home outside of North Carolina. The installer moved the purchased goods outside of North Carolina at the buyer's request. The Installer was not an agent or employee of the taxpayer but instead was hired directly by the buyer.

The taxpayer-seller did not charge North Carolina sales tax on the purchased goods. The taxpayer argued that the sale was not subject to North Carolina sales tax. However, the Department of Revenue concluded that the sale had taken place in North Carolina since the contract sale was entered into by the Buyer in North Carolina, even though part of the purchase price was not payable until delivery to the buyer's home state. The fact that the Buyer later transported the property out of North Carolina did not affect this result, since (1) the taxpayers sold the merchandise in North Carolina and (2) the Buyer took possession of the property in North Carolina through their agent (the Installer).

Thus, sales of tangible personal property delivered in North Carolina to a buyer or an agent of the buyer (if the agent is not a common carrier) are subject to North Carolina sales tax regardless of whether the buyer (or his agent) subsequently transports or employs someone else to transport the property out of North Carolina.

Note: In this case, the Department of Revenue concluded that the sale had taken place in North Carolina since the retail contract was entered into in North Carolina even though part of the purchase price was not payable until the merchandise was delivered to the out-of-state location of the buyer. This case reminds us that North Carolina sales tax will be assessed on the sale transaction, unless the sale transaction is consummated outside of North Carolina. Usually, the sale transaction will be deemed to be consummated inside of North Carolina unless the entire purchase price will not be payable to the North Carolina seller until the merchandise is delivered outside of North Carolina.

Also note that this case illustrates the importance of using a common carrier to affect out of state transactions. Again, if a common carrier is used by the buyer or seller to deliver goods out of state, the transaction may be deemed to have occurred outside of North Carolina, thus possibly exempting the sale from being deemed to be concluded inside of North Carolina. Also, the use of a common carrier (whether retained by the buyer or seller) may prevent a seller from establishing "nexus" with the other state so as to exempt the seller from being liable for collecting sales tax in the other state.

Of course, as this case also illustrates, if the buyer contracts with its own agent (who is not a common carrier), the Department of Revenue may well conclude that the delivery of the merchandise occurred in North Carolina when the buyer's agent took possession of the merchandise in North Carolina.

XII. Secretary of Revenue Decision No. 2006-218, North Carolina Department of Revenue, January 10, 2007 (Released February 13, 2007). North Carolina Retailer Held Liable for North Carolina Sales Tax on Sales of ATVs to Out-of-State Residents Absent Proof of Delivery to a Point Outside of North Carolina.

A North Carolina retailer, that made out-of-state sales of street bikes and all-terrain vehicles, was liable for North Carolina and applicable local sales and use taxes that should have been collected and remitted on those sales to out-of-state customers - because the taxpayer failed to provide adequate shipping documentation to verify proof of transportation and delivery to a point outside of North Carolina. Although the taxpayer provided their own homemade form that stated that sales tax had not been paid and that the customer would be responsible for the applicable tax in his or her own state, that was insufficient to exempt the sales to the out-of-state residents. Acceptable proof of transportation and delivery to a point outside the state must be presented in order for an exemption for a sale in interstate commerce to apply.

In this case, during the audit period, the Taxpayer was engaged in business as a North Carolina retailer whose principal business activity was the retail sale of street bikes, dirt bikes, and all-terrain vehicles (ATVs). The Taxpayer made sales of tangible personal property at the Taxpayer's place of business in North Carolina. Additional tax was assessed against the Taxpayer for the audit period based on the Taxpayer's failure to collect and remit sales tax on claimed out-of-state sales which were actually delivered to its customers in North Carolina.

The Taxpayer required that its customers, who lived outside North Carolina, to complete a form entitled "Sales Use Tax Notification." This form stated that North Carolina sales tax had not been paid and that the customer would be responsible for the applicable tax in his state. The Taxpayer did not collect or remit sales tax on the sale to customers who filled out the Taxpayer's form entitled "Sales Use Tax Notification."

The Taxpayer produced "Sales Use Tax Notification" forms for tangible personal property delivered in North Carolina and tangible personal property delivered out of North Carolina. However, The Department did not accept the Taxpayer's "Sales Use Tax Notification" form as adequate documentation to exempt sales to out-of-state residents, because some customers actually picked up the unit at the dealer's North Carolina location. The Department assessed sales tax on motorcycles and ATVs sold to out-of-state residents who actually picked up the unit at the dealer's North Carolina location.

The auditors mailed certified letters to out-of-state customers to determine where they took possession of their purchase of any off road vehicle from the Taxpayer. If the customer returned the letter and stated that the merchandise purchased was delivered to the customer out of state, the sale was exempted as a sale in interstate commerce and not taxed in the audit report. If the customer returned the letter and stated that the merchandise was picked up at the Taxpayer's business location in North Carolina, the sales were included in the audit report as a taxable sale.

If no response was received from the customer, the sale was considered delivered in North Carolina and thus taxable.

Conclusions of Law

In this case, the Taxpayer could not provide adequate documentation of out-of-state deliveries for the sales which were assessed North Carolina sales tax. Sale and Use Tax Technical Bulletin 42-1 A provides a definition of "out-of-state sales" and provides a list of the acceptable documentation to verify proof of transportation and delivery to a point outside of North Carolina. In order for an exemption for a sale in interstate commerce to apply, there must be "acceptable proof" of transportation and delivery to a point outside the State.

Where the delivery of goods sold is in the taxing state and is accepted within the taxing state, a sales tax may lawfully be imposed upon the transaction.

> **Note:** In this case, the Taxpayer did not maintain adequate shipping documentation for the sales where the Department assessed sales tax. So, the sales in question were subject to the general rate of State and applicable local sales and use tax.

XIII. Taxable Portion of Trade Booth and Display Sales Price Includes Custom Portion of Design Costs.

In Secretary of Revenue Decision No. 2003-262, the taxpayer was engaged in the business of making retail sales of trade booths, displays and other materials. The taxpayer also performed creative services for its clients which did not involve the sale of tangible personal property. The taxpayer, in some cases, collected and remitted sales tax on materials that it produced and sold to clients; however, the taxpayer never charged sales tax on what the taxpayer characterized, and separately billed, as "creative services" rendered in association with the production of sold items. According to the taxpayer, the separate charges for these creative services are not part of the sales price subject to sales tax.

The Department of Revenue took the position that the "sales price" of the sold items should include the taxpayer's separate charges for creative services that were performed "in association with the production" of the tangible personal property. According to the Department of Revenue, the "true object" of the agreements between the taxpayer and its clients in these transactions was the trade booths, displays or other tangible personal property that ultimately was received by the clients.

The Department of Revenue cited N.C.G.S. 105-164.3(37) which requires that, although creative services may have been rendered in association with the production of the items, because the sales price to which the tax applies should be the total amount for which the property is sold, including all charges for services rendered in the fabrication, manufacture or delivery of the property, then the amount charged for the creative services should be considered part of the sales price of property subject to tax. The Department of Revenue also cited Sales and Use Tax Bulletin 24-1B, which provides that, where advertising agencies make retail sales of tangible personal property, the sales price to which the sales tax applies is the total amount for which tangible personal property is sold, including all charges for services rendered in the production, fabrication, manufacture, or delivery of property.

In its Decision, the Secretary of Revenue agreed with the Department and concluded that the sales tax should have been assessed on the charges for creative design services. The Secretary was not swayed by the taxpayer's assertion that the design services are complete and are given to the client, such that title to the design passes to the client irrespective of whether or not the client ultimately purchases finished products from the taxpayer. The Department of Revenue likewise was not swayed by the fact that the creation of the ultimate tangible personal property was only the second indiscreet transaction that would not have occurred but for the client's earlier acceptance of the design services.

XIV. Use Tax Assessed on Construction Materials Purchased Outside of North Carolina But Used for Assembly in North Carolina (CCH 202-314).

In the case of Morton Buildings, Inc. v. Tolson, North Carolina Court of Appeals, 615 S.E.2d 906 (August 2, 2005), Morton Buildings, Inc. was a construction contractor in the business of producing, selling and erecting prefabricated warehouses and other buildings for use on farms and in industry in 40 states. Morton purchased lumber, steel and other building materials outside of North Carolina and assembled them into building components which were stored in Pennsylvania and Ohio. Ultimately, however, the manufactured assembly components were incorporated in the buildings constructed in North Carolina.

Initially, Morton paid use tax on the purchased materials, but then sought a refund of the North Carolina use tax paid on the basis that the purchased steel, lumber and other materials were assembled in the component parts outside the State of North Carolina (in Pennsylvania and Ohio).

At issue in this case was N.C.G.S. § 105-164.6(b) which provides that use tax shall be imposed on the purchase "of tangible personal property purchased inside or outside [North Carolina] that becomes a part of a building or other structure in [North Carolina]." Morton argued that the purchased steel and lumber outside of North Carolina did not become "part of a building or other structure in North Carolina" since the lumber and steel were used to assemble component parts ***outside*** of North Carolina. Morton also therefore argued that the purchased materials were "consumed" and "transformed" into building components outside of North Carolina (in Ohio and Pennsylvania) and thus, it was the building components that became "part of the building or other structure" in North Carolina.

The Court of Appeals, however, held that the clear language of N.C.G.S. § 105-164.6(b) provides no limitation that tangible personal property must be in the same form in which it was purchased in order to be taxable by North Carolina. According to the Court of Appeals, the materials incorporated into the building components were still tangible personal property subject to the North Carolina Use Tax. The Court stated that the Use Tax should impose the same burden on out-of-state purchases as the sales tax imposes on in-state purchases, and builders should not be able to gain an advantage by purchasing materials outside North Carolina. Thus, the use of tax must be paid on all tangible materials, wherever purchased, that are ultimately used in North Carolina buildings.

NOTE: Session Law 2005-276 amended N.C.G.S. § 105-164.6(a) to make it clear that the use tax also applies to tangible personal property purchased inside or outside of North Carolina that becomes part of a building or another structure. **Moreover, Session Law 2005-276 also amended § 105-164.6(b) to provide that, if purchased property becomes part of a building or other structure in North Carolina and the purchaser is a contractor or subcontractor, the subcontractor, the contractor and the owner of the building are jointly and severally liable for any unpaid use tax.**

XV. Contractor's Purchases of Equipment Were Ineligible for the Manufacturer's Tax Rate.

In Secretary of Revenue Decision No. 2006-114 (released October 31, 2006), the Secretary of Revenue held that equipment purchased by a contractor, for use in fabricating gutters and down spouts and which were used by the taxpayer in fulfilling its performance contracts, was subject to the North Carolina general sales and use tax rate, rather than the reduced sales and use tax rate that was previously applied to purchases of mill machinery and equipment by manufacturers.

In this case, the Secretary of Revenue held that, because the taxpayer fabricated the gutters and other items for use in its gutter installation and roofing business, and not for sale to others, the taxpayer did not qualify as a "manufacturer."

Also, although the taxpayer contended that the items it fabricated were sold at retail by its sister corporation, the taxpayer failed to substantiate its claim. Moreover, the Secretary of Revenue held that, even if the taxpayer had been able to prove that the items were sold by its sister corporation, the equipment purchases (which were used to fabricate the gutters and down spouts) were still ineligible for the reduced tax rates - because only purchases made by a manufacturing industry of plant are eligible for the reduced tax rate.

In this case, the Secretary of Revenue noted that, in the context of N.C.G.S. 105-164.4A(2), a "manufacturing industry or plant" is an entity which manufactures articles for sale or some equivalent purpose. In the context of N.C.G.S. 105-164.4A(2), "machinery" is machinery used by a "manufacturing industry or plant" to create articles for sale, not which is used to create an article for use in the conduct of its creator's own business.

In this case, the taxpayer was not deemed to be a "manufacturing industry or plant," as that term is used in N.C.G.S. 105-164.4A(2), for the reason that its "dominant and principal" purpose is that of a contractor. Contractors, instead, are liable for the sales or use tax on their purchases of materials used in fulfilling their performance contracts. Contractors are not manufacturers, even if they transform raw materials into new and different product when it is used in fulfilling the contractor's performance contracts. Thus, the preferential tax rate incentive extended to manufacturers does not apply to contractors.

In this case, the taxpayer did not make any retail or wholesale sales of tangible personal property. The taxpayer did not provide any evidence that the equipment in question was used primarily by it to fabricate articles for sales by its sister corporation to others. Moreover, even if the taxpayer had been able to do so, the applicable statutes (N.C.G.S. 164.4A(2)) requires that the machinery be sold to the manufacturing industry or plant and, in this situation, the machinery or equipment was sold to the taxpayer, a contractor.

Note: Effective January 1, 2006, mill machinery and mill machinery parts and accessories are exempt from the sales and use tax, but are subject to a privilege tax at the rate of 1% of the sales price paid on the item purchased with a maximum of $80 per article.

Note: In this case, the taxpayer also claimed that it had received erroneous verbal advice from a Department of Revenue representative. Of course, this erroneous verbal advice is of no benefit to the taxpayer since N.C.G.S. 105-264 provides that taxpayers are entitled to rely upon only written advice by the Department of Revenue and cannot rely upon oral advice.

XVI. Out of State Retailer Had "Nexus" With North Carolina For Sales Tax Purposes.

In Secretary of Revenue Decision No. 2005-75 (released October 26, 2005) (CCH ¶202-358), the Secretary of Revenue ruled that an out-of-state retailer, that sold well drilling rigs to North Carolina customers, was required to collect sales and use taxes on such sales because the taxpayer was "engaged in business in North Carolina." The taxpayer's employees and sales representatives took orders for the sale of tangible personal property in North Carolina. Its employees delivered and installed repair parts in North Carolina and its repair representatives transacted business on and for its behalf in North Carolina. Such actions demonstrated that the taxpayer was "engaged in business" in North Carolina.

XVII. Land Surveying Taxpayer Had to Pay Use Tax on its Purchases of Items Used For Aerial Photography; North Carolina Tax Review Board Administrative Decision No. 451 (September 4, 2004, released June 1, 2005)

In this Tax Review Board Administrative Decision, the taxpayer was a land surveying company located in North Carolina, which provided aerial topography mapping services within and without North Carolina. These aerial topography mapping services were non-taxable (not subject to sales tax) when the taxpayer ultimately sold these services to the taxpayer's customers. However, in the course of providing land surveying services to its customers, the taxpayer purchased aerial photography, undeveloped film, contract prints, negatives, data tapes, and compact discs from certain subcontractors. The NC DOR took the position that these purchases were subject to North Carolina Use Tax.

The taxpayer contended that its supplying subcontractors were providing **services** that were an **integral step** in the process of providing the taxpayer's non-taxable aerial photography services, and therefore that these purchases should not be subject to the North Carolina Use Tax. The taxpayer further contended that any tangible personal property produced by these subcontractors- suppliers were merely incidental to the professional services being rendered by the taxpayer and that the tangible items were merely an instrument of the services being performed by the taxpayer. Therefore, the taxpayer argued that the "true object" of the transactions at issue was its purchase of "information," and not the transfer of tangible personal property.

In its final decision, however, the Secretary of Revenue determined that the "true object" of the transaction was the contract prints, negatives, data tapes and compact discs because these were the items that the taxpayer must obtain and use in order to provide its non-taxable topographical services to its customers. Therefore, the Secretary of Revenue ruled that the taxpayer purchased tangible personal property that it used in providing its aerial topographical services, and therefore the taxpayer was subject to the North Carolina Use Taxes on these purchases. (CCH § 202-310).

XVIII. **Sales of Wedding Videos Are Sales of Goods And Not Sales of Services.**

In Secretary of Revenue Decision No. 2004-199 (Released October 28, 2005), the taxpayer filmed and sold professional wedding videos to its North Carolina customers. The taxpayer argued that sales of wedding videos were not subject to North Carolina sales tax because the taxpayer was providing a service and not a tangible good.

The North Carolina Department of Revenue, however, held that the "true object of the transaction" was the completed and edited video tape which was a tangible product and not a service. (CCH 202-318)

XIX. **Also, Sitting Fees and Overtime Charges Paid to Videographer Are Also Subject to North Carolina Sales Tax.**

In Secretary of Revenue Decision 2004-3-48 (Released October 28, 2005), the Department of Revenue held that sitting fees and overtime charges, which were charged for the taxpayer's presence at a wedding to film video or take photographs, were also subject to the North Carolina sales tax since the "true object" of these transactions was the sale of tangible personal property in the form of wedding photographs or videos. (CCH 202-328).

XX. **North Carolina and South Carolina Departments of Revenue Join Forces to Capture Use Tax on Out-of-State Purchases of All Terrain Vehicles and Watercrafts.**

A. Background. The North Carolina and South Carolina Departments of Revenue have found that there is a growing problem of sales tax non-compliance for purchases of watercraft and all train vehicles (ATVs) purchased from retailers along the North Carolina and South Carolina border. Both state agencies have found that, in many cases, sales tax is not charged on those purchases because, according to the dealer's records, the delivery of the vehicle or boat is made to a customer in the neighboring state (for example, where a North Carolina resident purchases watercraft or ATVs from a South Carolina dealer which are then delivered by the dealer to the North Carolina purchaser).

Although North Carolina law requires that a North Carolinian, who purchases ATVs or watercrafts in South Carolina must pay use tax on the purchase, the use tax often is not paid by the North Carolina purchaser who buys watercraft or ATVs from a South Carolina retailer.
The same is true of South Carolinians who purchase ATVs or watercrafts from a North Carolina retailer where delivery of the watercraft or ATVs is being made in South Carolina.

B. North Carolina and South Carolina Join Forces. To combat these problems, the North Carolina and South Carolina Departments of Revenue have agreed to share information on purchases of ATVs or watercraft from retailers along the North Carolina and South Carolina border. See NC DOR Announcement dated April 28, 2004.

XXI. NC Directive Aimed At Non Taxed Purchases of ATVs For Alleged Farm Purposes.

In North Carolina Announcement Dated April 28, 2004, the North Carolina Department of Revenue stated it would focus on the misuse of state agricultural sales tax exemption certificates furnished by customers who attempt to purchase ATVs at the North Carolina agricultural sales tax rate of 1%. Normally, this 1% sales tax rate is only available for purchases of farm machinery and is not generally applied to purchases of ATVs, unless the ATVs are used in connection with farm activities. The North Carolina Department of Revenue auditors have found that, in the 2004 fiscal year, there was substantial misuse of the agricultural certificate (which claimed that purchased ATVs are purchased for farm use purposes) and that the Department of Revenue has recovered approximately $2,000,000 of additional use tax owed during the 2004 fiscal year.

PART FIVE
CORPORATE INCOME AND FRANCHISE TAX DEVELOPMENTS.

I. Small Business Health Care Credit.

Small businesses with **fewer than 26 employees** may claim a credit against North Carolina corporate income tax or personal tax of up to $250 per employee if they pay at least 50% of their employees' qualified health insurance premium costs. The credit may only be claimed for health insurance premiums paid for eligible North Carolina employees whose total annual wages received from the business does not exceed $40,000. The amount of the credit per employee is the lesser of (1) $250, or (2) the taxpayer's actual cost of providing health benefits for the taxable year.

The credit is available for the 2007 and 2008 taxable years.

Note The "Double Tax" Benefit: There is no federal add back if the credit is claimed. So, North Carolina taxpayers get a "double tax benefit" for the credit and for the income tax deduction.

Note: **Special Rules Apply for Out-of-State Employees**. It appears that, if the North Carolina employer also has employees outside of North Carolina, the North Carolina employer also must pay for the health insurance of the out-of-state employees in order to claim the North Carolina tax credit for health insurance paid for the benefit of in-state North Carolina employees. However, the North Carolina employer must "apportion" the credit between its employees inside and outside of North Carolina.

(S.B. 1741, Laws 2006, effective July 1, 2006, except as noted above.)

II. North Carolina Does Not Adopt The Federal U.S. Production Activities Deduction.

Under the American Jobs Creation Act of 2004, U.S. Congress adopted a new U.S. Production Activities Deduction for corporate and pass through taxpayers for tax years after December 31, 2004. New IRC Section 199. However, the North Carolina Department of Revenue did not adopt conforming changes for North Carolina business taxpayers (Senate Bill 622).

NOTE: Since the U.S. Production Activities Deduction also applies to pass through taxpayers (such as S corporations, LLCs, estates and trusts), as well as C corporations, there will now be an "add back" for North Carolina tax purposes which will be reflected on individual tax returns, as well as on corporate tax returns, S Corp returns and partnership tax returns.

III. Department of Revenue Issues Announcements Regarding Bonus Depreciation Deductions.

A. General. North Carolina did not adopt the additional first year depreciation provisions in the Federal Job Creation and Workers Assistance Act of 2002 or the Federal Jobs and Growth Tax Relief Reconciliation Act of 2003. Instead, an adjustment was required on the 2002, 2003, and 2004 returns for a certain percentage of the first year of depreciation claimed on the federal return for the applicable year. In 2005 and thereafter, any amount of additional first year of depreciation that an individual added to the federal taxable income on the 2002, 2003 or 2004 North Carolina returns may be deducted in five equal installments beginning with the North Carolina tax return for 2005.

Effective for taxable years beginning on or after January 1, 2005, NCGS 105-134.6(b)(17) and NCGS 105-130.5(e)(21) allow for a deduction for the amount that special bonus depreciation under § 168(k) or §1400L of the Internal Revenue Code that was added to federal taxable income in 2002, 2003, 2004. The deduction must be claimed in five equal installments in the first five taxable years beginning on or after January 1, 2005.

B. Bonus Depreciation Deductions Beginning in 2005. Under North Carolina Department of Revenue Announcement dated January 5, 2006, the Department of Revenue advises that any amount of additional first year depreciation that an individual added to federal taxable income on the 2002, 2003, or 2004 North Carolina returns may be deducted in five equal installments beginning with the North Carolina tax return for 2005.

Example: Assume an individual added back the following amounts of additional first year depreciation on line 36 of a North Carolina returns over the three previous tax years.

2002	$4,000
2003	$2,000
2004	$6,000
Total:	$12,000

Since the individual taxpayer added back $12,000 of bonus depreciation during 2002 through 2004, the individual may deduct $2,400 ($12,000 x 20%) on the 2005 North Carolina tax return and $2,400 on each return for the next four tax years.

C. Bonus Depreciation Deduction for Pass Through Entities. The NC Department of Revenue issued Announcements (on March 7, 2006) which discusses the bonus depreciation deduction for pass through entities. This announcement also advises what will happen to the NC deduction whether there is a change in ownership or merger of the pass through entity. See NC DOR Announcement Dated March 7, 2006.

1. Change in Ownership. With respect to pass through entities in which there is a change in ownership in 2005 at the partner or shareholder level, the new owner is not entitled to share in the depreciation deduction claimed on the pass through entity return because the new owner would not have added back the depreciation in 2002, 2003 or 2004 for NC tax purposes. Therefore, in the case of a partnership of S corporation, the total deductions attributable to those special bonus depreciation for each individual partner or S corporation shareholder would not equal the total deduction otherwise available.

However, a former partner or S corporation shareholder **is entitled** to the deduction allowed for any special bonus depreciation added back on the partner's or shareholder's individual North Carolina tax return in 2002, 2003 or 2004. See NC DOR Announcement Dated March 7, 2006.

2. Merger of Entities. When two entities merge, the new entity is not entitled to the deduction for special bonus depreciation because the new entity did not add back the depreciation in 2002, 2003 or 2004 for NC tax purposes. However, the new individual owners of the entity - that existed prior to the merger - would be entitled to the deduction if, on their individual income tax returns for 2002, 2003 or 2004, the owners added back the depreciation that was passed through to them by either of the original entities for NC tax purposes. See NC DOR Announcement Dated March 7, 2006. Also See NC DOR Notice Dated January 5, 2006.

3. Tax Conversions. Also, consider what might happen if an S corporation (that claimed the add back in 2002, 2003 or 2004) since has converted to a C corporation, or vice versa? The NC Department of Revenue takes the position that **only** the taxpayer, who incurred the add back, may claim the NC deduction. So, in the case of S-to-C or C-to-S conversions, the NC deduction is lost!

D. What if the Taxpayer Disposes of an Asset on which additional first year depreciation was added back? According to the North Carolina Department of Revenue Released dated January 5, 2006, if a taxpayer disposes of an asset on which additional first year depreciation was added back on 2002, 2003 or 2004 North Carolina return, the taxpayer is entitled to claim the 20% deduction over the five year period, even though the taxpayer no longer owns the asset.

IV. New North Carolina Tax Credit for Movie Production Companies.

In 2005, Session Law 2005-276 added a new North Carolina tax credit for companies that produce movies in North Carolina. The new North Carolina tax credit is equal to 15% of certain qualified expenditures (for goods or services purchased in North Carolina) involved in producing movies in North Carolina. N.C.G.S. § 105-130.47(b). However, the North Carolina tax credit does not apply to salaries paid to "highly compensated individuals" (defined as individuals receiving more than $1,000,000). N.C.G.S. § 105-151.29(a).

The 15% tax credit cannot be passed through to owners of a passthrough entity. N.C.G.S. § 105-130.47(c) and N.C.G.S. § 105-151.29(c). Instead, the passthrough entity will receive the tax refund from the NC Department Revenue which the passthrough taxpayer will use in the conduct of its business or will distribute to the owners of the passthrough entity.

Under the 2005 Tax Act, the tax credit would not be allowed for expenses otherwise deducted for North Carolina tax purposes. N.C.G.S. § 105-130-47(i) and N.C.G.S. § 105-151.29(i). Also, see N.C.G.S. § 105-130.5(a)(18). This effectively meant that the taxpayer had to "add back" the qualifying expenses, for which the NC credit was claimed, as an "add back" to federal taxable income. Presumably, this "add-back" to state taxable income was designed to prevent taxpayers from obtaining a double tax benefit for North Carolina state tax purposes which would be available by claiming both the production company expense credit as well as the deduction for the expense itself.

Beginning with the 2007 taxable year, taxpayers that claim the production company expense credit against North Carolina corporate income or personal income tax are no longer required to add back to federal taxable income the expenses for which the credit is claimed when computing their North Carolina personal income tax or corporate income tax liability. This change will now provide taxpayers with a **double tax benefit** for qualifying movie production expenditures in the form of a NC credit **<u>and</u>** a NC tax deduction.

Ch. 220 (H.B. 1522), Laws 2006, effective as noted above.

V. <u>Changes in Franchise Tax Involving Corporate-Affiliated LLCs</u>.

A. <u>Background</u>. Since ownership interests in LLC and partnership investments traditionally have not been subject to North Carolina corporate franchise taxation, some corporate taxpayers have sought to take advantage of an unintended loophole in the tax law, and to avoid North Carolina franchise tax, by transferring certain assets to a controlled limited liability company ("LLC"). This technique would include the transfer of valuable assets (such as real estate, investment assets and other intangible assets) to either an in-state or out-of-state LLC to attempt to avoid the corporate franchise tax on the value of these assets.

B. <u>2001 Tax Law Amendments</u>. In 2001, House Bill 1157 amended N.C.G.S. 105-114 by adding a new subsection (c) to provide that, if a taxpayer-corporation and related parties own 70% or more of the membership interests of a North Carolina or out-of-state LLC (such that 70% or more of the LLC assets would be distributed to the corporation upon dissolution of the LLC), then a pro rata portion of the LLC's income, assets, liabilities and equity will be attributed to that member-corporation for franchise tax purposes.

C. <u>2004 Tax Act Amendments</u>. Senate Bill 51 (Session Law 2004-74) has made several important changes to N.C.G.S. 105-114.1 with respect to the franchise tax.

1. **New Concept of Affiliated Corporations**. Before the 2004 Tax Act, it would be possible to avoid the 70% LLC rule by allowing brother/sister corporations (under common ownership) to transfer appreciated assets to a new LLC. Since no one brother/sister corporation would own more than 70% of the new LLC, all brother/sister corporations could possibly avoid the franchise tax.

The new 2004 Tax Act closes this "loop hole" by providing that, for purposes of applying the 70% test, all LLC capital interests owned by an "affiliated group of corporations" would be aggregated. Revised N.C.G.S. 105-114.1(b).

2. **Treatment of Individual Members**. At the same time, SB-51 recognizes that, in some cases, shareholders will form an LLC with their corporations to own real estate for business purposes that are independent from any desire to avoid North Carolina franchise taxes.

So, the revised N.C.G.S. 105-114 now provides that any LLC interests owned by a shareholder of an affiliated corporation are not attributed to the LLC interests owned by the corporation-LLC member for purposes of the 70% rule.

3. **De Minimis Exception**. The new law exempts the first $150,000 of value of assets held by an LLC from imposition of franchise tax assessed on a corporate member of an LLC. This exemption is roughly equal to the $200 LLC annual report fee already being paid by the LLC anyway.

4. **70% Rule Replaced With a 50% Rule**. Finally, SB-51 has changed the "more than 70% test" with a new "more then 50%" rule, effective as of January 1, 2005 for 2004 corporate tax returns. This means that corporations (or affiliated corporations) owning more than 50% of an LLC's capital interests in 2004 will owe franchise tax on 100% of the value of the LLC's assets.

5. **Effective Date**. The new rules discussed in Parts 1-4 above are effective retroactively for 2003 franchise taxes reported on 2002 and 2003 tax returns. This means that additional tax may be due for those periods (or perhaps a refund due to the taxpayer).

D. Note the New 50% Rule. The new rules **only apply** where the taxpayer corporation (and affiliated corporations) own **50% or more** of the LLC. Presumably, this leaves open the possibility that a corporation can create an LLC in which it owns **less than 50%** of the LLC membership interests with some third party (perhaps such as the corporation's shareholders) owning the other 51%. Presumably, this leaves open the possibility of using a "less than 50% owned" LLC to avoid North Carolina franchise tax because of the "bright line" 50% rule.

E. Possible Planning Options? Notwithstanding the new rules, perhaps there are still some tax planning options. Consider the following two options which come to mind.

(1) <u>Use of A Partnership Between the Corporate Parent and Subsidiary LLC</u>. Consider what would happen if a Corporation creates a subsidiary partnership (general or limited) between the Corporation and a subsidiary LLC holding real property? In this case, the intermediary partnership is not subject to North Carolina franchise taxation since it is a partnership rather than a corporation. Even if the ultimate parent corporation owns 99.9% of the subsidiary partnership, the partnership (and its majority corporate partner) arguably would not be subject to franchise tax, even if it owns 100% of the subsidiary LLC.

NOTE: The North Carolina Department of Revenue is already aware of this transparent attempt to avoid North Carolina franchise tax and will be quick to challenge its use.

(2) <u>Convert a Corporation to an LLC and Then Make An Election to Have the LLC Taxed As a Corporation</u>. Another possible strategy involves converting a North Carolina corporation to a North Carolina limited liability company, and then filing an election with the Internal Revenue Service to have the new LLC taxed as a corporation for federal income tax purposes.

The idea here is that, by converting the North Carolina corporation to a North Carolina LLC, the new converted entity arguably would not be subject to the North Carolina franchise tax, since the North Carolina franchise tax statue only applies to corporations and specifically does not apply to North Carolina limited liability companies.

There are two steps to implementing this strategy option. The first step would be to convert the North Carolina corporation to a North Carolina LLC by filing Articles of Conversion with the North Carolina Secretary of State. The second step would involve filing an election with the IRS on behalf of the new LLC to elect to be taxed as a corporation for federal and North Carolina corporate income tax purposes. By filing the election to be treated as a corporation for federal and North Carolina income tax purposes, the converted entity presumably would not be treated as having liquidated and converted to an LLC for federal and North Carolina income tax purposes.

N.C.G.S. § 105-114 through N.C.G.S. § 105-125 deals with application of the North Carolina franchise tax to North Carolina corporations. Section 105-114(a) provides that the franchise tax shall apply to "corporations." Section 105-114(b)(2) defines a "corporation" and this subsection specifically states that the term "corporation" does not include a limited liability company.

At the same time, the North Carolina Department of Revenue apparently recognizes the "check the box" concept of state taxation. That is, the Department of Revenue apparently recognizes that, for North Carolina corporate income tax purposes, a North Carolina LLC may elect to be taxed as a North Carolina corporation for state income tax purposes. The parallel "check the box" rules for federal income tax purposes will also allow a North Carolina LLC to be taxed as a corporation for federal corporate tax purposes. N.C.G.S. 105-130.2(1a) and (5) define a "corporation" for North Carolina income tax purposes to include an LLC that is classified as a corporation for federal income tax purposes, presumably under the federal "check the box" rules.

Thus, while the franchise tax statute (N.C.G.S. 105-114) specifically excludes LLCs from its application, the North Carolina corporate income statute specifically addresses LLCs that elect to be taxed as a corporation for income tax purposes. Therefore, one could argue that, since the North Carolina Legislature did not decide to define "corporations" for franchise tax purposes in the same manner that it defined "corporations" for state corporate income tax purposes, the North Carolina Legislature may have intended that the franchise tax would not apply to an LLC that elects to be taxed as a corporation.

F. New North Carolina Law. Beginning with 2007 taxable year, LLCs that elect to be treated as **C Corporations** for federal income tax purposes are now subject to the North Carolina corporation franchise tax. Such LLCs are eligible for the non-refundable credit against the franchise tax equal to the difference between the annual report fee for corporations (currently $20) and the annual report fee for LLCs (currently $200).

Note: This means that we can no longer use LLCs, that elect to be taxed as **C Corporations** for income tax purposes, to avoid the North Carolina franchise taxes.

2006 Senate Bill 1741.

G. But, S Corporations Are Not Covered Under the New Rules! The new 2006 franchise tax changes only specifically apply to Corporations that convert to an LLC and that then elect to be taxed as a C Corporation. So, there may be a "loop-hole" here - in that it may be possible to reduce franchise taxes by having a corporation convert to an LLC that then elects to be taxed as an S Corporation, rather than as a C Corporation, for federal tax purposes.

H. Also, Beware of Possible Criminal Penalties! Moreover, taxpayers should be aware that the new N.C.G.S. 105-114(c) also provides:

> A taxpayer who, because of fraud with intent to evade tax, underpays the tax under this article on assets attributable to it under this subsection is guilty of a Class H felony...

Thus, the possibility of criminal sanctions should be considered before engaging in any attempts to avoid the North Carolina franchise tax.

I. **Effective Date**. The new rules are applicable to 2006 North Carolina tax returns to be filed in 2007, since the "privilege tax" is a tax assessed for the privilege of doing business in North Carolina for 2007.

VI. New Time Limits for Filing Corrected Corporate Income Tax Returns After Additional Federal Assessments.

House Bill 1892 has amended several different corporate income tax provisions pertaining to the requirement to file amended North Carolina returns to correct for a federal redetermination made after June 30, 2006. Under House Bill 1892, N.C.G.S. 105-130.20 and N.C.G.S. 105-159 have been amended to provide that taxpayers will no longer have two (2) years to file corrected income tax returns after a federal redetermination of the taxpayer's taxable income. Now, taxpayers will only have six (6) months to file corrected returns with the NCDOR. If the taxpayer fails to file amended returns within six (6) months, the taxpayer will forfeit any refunds due by reason of the redetermination. And, watch out for the "failure to file" penalty!

Note: The new rules apply to federal redeterminations made by the IRS after June 30, 2006.

VII. North Carolina Court of Appeals Unanimously Rules Against "The Limited."

In A&F Trademark vs. Tolson, the North Carolina Court of Appeals unanimously ruled that the parent trademark holding company, which owned various retail subsidiaries (such as Victoria's Secret, Abercrombie & Fitch, Limited Too and Lerner) had "nexus" with North Carolina for income and franchise tax purposes based on the holding company's licensing of certain trademarks to their retail subsidiaries operating in North Carolina.

NOTE: The North Carolina Supreme Court and the U.S. Supreme Court have refused to review the A&F Trademark, Inc. case.

NOTE: Although "The Limited" case only directly involves $2 Million of taxes at issue, the North Carolina Department of Revenue believes this case is a $150 Million issue due to the widespread use of this tax planning technique.

NOTE: Notwithstanding the decision in The Limited case, the North Carolina Department of Revenue believes that many North Carolina corporations are still using out-of-state licensing companies to avoid North Carolina taxation through the use of these out-of-state licensing companies. Accordingly, in connection with "Project Compliance" (discussed below), the Department of Revenue intends to focus increased audit attention on these out-of-state licensing companies. Also note that, under the "Voluntary Compliance Program" (also discussed below), these out-of-state licensing companies are encouraged to comply with North Carolina rules.

ALSO NOTE: The A&F Trademark case involved the 1992, 1993 and 1994 tax years. Since that time, N.C.G.S. 105-130.7A was enacted to provide that royalty payments, paid and received between related taxpayers for the use of trademarks within North Carolina, are "income derived from doing business in North Carolina." N.C.G.S. 105-130.7A also now provides for alternative reporting requirements for payments made to an out-of-state licensing company. Under the new rules, the North Carolina taxpayer and the out-of-state related company can elect to (1) have the out-of-state licensing company pay North Carolina tax on royalty income, or (2) allow the North Carolina company to exclude the royalty payments from North Carolina corporate income tax deductions.

NOTE: As discussed further in Part Six below, the North Carolina Department of Revenue will focus additional audit attention on corporate restructures designed to understate North Carolina corporate tax liabilities.

VIII. New Royalty Reporting Requirements: North Carolina Income Tax Trademark Royalty Requirements Are Extended to Apply to Royalties Received from Patents and Copyrights.

A. Introduction and Background. Before 2001, a North Carolina corporation could use a wholly-owned, out-of-state subsidiary corporation to divert income to the out-of-state subsidiary by paying royalty fees to the out-of-state wholly-owned subsidiary. This is how this tax strategy previously worked:

A North Carolina parent corporation would create a wholly-owned subsidiary in another state (such as Delaware). The North Carolina parent corporation would then assign certain intellectual trademark property rights to the out-of-state subsidiary. The North Carolina parent would then pay a royalty fee to the out-of-state subsidiary for the parent's use of the trademark. This arrangement, of course, created a royalty deduction available to the North Carolina parent (for North Carolina income tax purposes); however, since the out-of-state subsidiary was not subject to North Carolina corporate income tax, the royalty income paid to the out-of-state subsidiary was not subject to North Carolina taxation.

Under HB 1157 (enacted on August 2, 2001), Section 105-130.7A was enacted to provide that royalty payments paid and received between **"related taxpayers"** for use of **trademarks** within North Carolina are "income derived from doing business" in North Carolina. Thus, under new

Section 105-130.7A, royalties received for use of trademarks became subject to North Carolina taxation, even if received by an out-of-state payee, where the trademarks were to be used by the licensee-parent in the State of North Carolina.

B. Allowable Options for Trademark Royalty Payment Reporting. However, the new tax rules allow the payer and payee to elect how to treat these payments for North Carolina income tax purposes. These royalty payments now can **either** be (1) deducted by the payer and included in the income of the payee, **or** (2) added back to the income of the payer and excluded from income of the recipient.

Note: Who are "Related Parties?" This new provision only applies to royalty payments when the recipient and the payer are related taxpayers (as defined in Section 318 of the Internal Revenue Code).

C. New 2006 Patent and Copyright Royalty Reporting Rules. Under 2006 Senate Bill 1741, the North Carolina corporate income tax trademark royalty reporting requirements are **extended** to apply to royalties received from patents **and** copyrights, effective beginning with the 2006 taxable year. Under the new rules, effective for the 2006 tax year, taxpayers must report royalty payments received for the use of patents and copyrights in North Carolina as income "derived from doing business" in North Carolina. If the recipient of the payments and the payer are related members, the payments either (1) can be included in the income of the recipient and deducted by the payer or (2) added back to the income of the payer and excluded from the income of the recipient. However, the payer need not add the payments back to its income if it can establish that the related member during the same taxable year then directly or indirectly paid, accrued, or incurred the payment to a person who is not a related member.

(S.B. 1741, Laws 2006, effective July 1, 2006, except as noted above.)

PART SIX
NEW ESC TAX RULES

I. <u>President Bush Signs the SUTA Dumping Prevention Act of 2004</u>.

On August 9, 2004, President Bush signed into law the SUTA Dumping Prevention Act of 2004 (PL 108-295). This Act requires states to take steps to curb "employer dumping" practices aimed at avoiding unemployment insurance taxes. **Note that the new law also requires that states assess civil and criminal penalties on employers who practice SUTA dumping, <u>as well as their business advisors</u> who promote the practice of SUTA dumping.**

Specifically, the new Bill requires states to strengthen their unemployment compensation laws to provide that:

1. If an employer transfers its business to another employer under the same ownership or control, the unemployment experience of the business is also transferred;

2. Unemployment experience will <u>not</u> be transferred to a person acquiring a business if that acquirer is not otherwise an employer and the acquirer acquired the business primarily to obtain a lower rate of contributions;

3. Unemployment experience shall, or shall not, be transferred in accordance with regulations prescribed by the Secretary of Labor to insure that higher rates of contributions are not avoided through the transfer or acquisition of a business; and

4. Civil and criminal penalties are imposed on persons who violate or attempt to violate, or who advise others to violate state laws implementing the preceding requirements.

States would also have to establish procedures to identify the transfer or acquisition of a business for SUTA dumping purposes.

NOTE: What about corporate restructuring to avoid other business expenses such as unfavorable worker's compensation premiums or outstanding tax liabilities? If we have clients who "fold down and re-incorporate" to avoid worker's compensation ratings or outstanding tax liabilities, will those employers fall under the new SUTA Dumping Act where SUTA expense reductions are also reduced?

The new Act seems to indicate that SUTA unemployment experience ratings of the transferor would also be transferred to the new acquirer, regardless of whether or not the transfer was specifically designed to accomplish SUTA dumping. Therefore, where the acquirer and transferor are under common control or management, the unfavorable rating will be transferred to the acquirer regardless of the purpose of the transfer. However, the new SUTA Dumping Act probably would not assess civil and criminal penalties against the business owners (or their advisors) unless (1) the purpose of the transfer was to reduce SUTA taxes, **or** (2) where the acquirer intentionally and knowingly failed to adopt the unfavorable unemployment experience ratings of the transferor.

II. Current North Carolina ESC Stance on "Successor" ESC Liabilities for Certain Purchasers of Businesses

A. Introduction and Background. In recent years, the North Carolina Employment Security Commission has become much more aggressive in asserting **successor employer liability** against taxpayers that purchase, or otherwise acquire, the businesses of a predecessor employer with a high ESC unemployment tax rating.

To a great extent, the ESC has become more aggressive due to its perception that some taxpayers may be engaging in "SUTA Dumping." In a classic SUTA Dumping case, an employer, with a high unemployment tax rating, will attempt to "restructure" its business structure in order to "dump" its high unemployment tax rate. Classic "SUTA Dumping" strategies include:

1. Selling the predecessor's assets to a related party with a lower ESC rate;
2. Merging one brother or sister company (with a high unemployment tax rate) into another brother/sister company (with a lower ESC tax rate);
3. Closing down one business and re-incorporating a new business; and
4. Having a business with a "high" ESC rating purchase a business with a lower ESC rating.

Arguably, however, the ESC has become somewhat "overzealous" in applying the ESC rules more broadly than originally intended. In fact, the ESC has been assessing higher SUTA tax rates in the case of brother-sister mergers, even in those cases where the mergers were designed to accomplish **business objectives** and which were **not** designed to reduce SUTA/ESC taxes.

Also, in the case of business acquisitions, the ESC has been quick to assess the seller's SUTA tax rate against the purchaser, even where the business purchase was in an "arm's length" transaction between unrelated parties. This is so even where the form of the acquisition is through an asset purchase rather than a stock purchase.

In these cases, the ESC often takes the position that the successor must assume the seller's SUTA/ESC tax rate, unless there has been some "break-in-service" of the employees of the seller (or bankrupt seller) before the purchase. In addition, in those cases where the seller has outstanding ESC taxes, the ESC will hold the purchaser liable for the Seller's outstanding ESC taxes.

Moreover, we have also seen the North Carolina ESC assess successor SUTA liability against the purchaser of a business through bankruptcy proceedings, even where the Bankruptcy Court's Sales Order absolved the purchaser of any liability for past obligations on the bankrupt seller. Fortunately, however, the North Carolina Legislature recently has amended the ESC tax rules for buyers who purchase a business through bankruptcy, where there is no common ownership among the purchaser and bankrupt seller.

B. Background of ESC/SUTA Rules.

1. General Unemployment Rating Rules. Currently, under the Employment Security Laws, the ESC tax rate is based each year on an "experience rating" which changes based upon unemployment claims filed in the previous year. In essence, the ESC tracks a "fund" which will either have a "credit" balance or a "debit" balance - depending upon whether contributions to the fund in the employer's name exceeds, or is less than, amounts paid out. In those cases where an employer has a "debit" balance in its fund (because payment of claims exceeds tax contributions), the ESC will increase the employer's ESC tax rate for the following year and the increased ESC tax rate will stay in effect until the debit balance is paid off.

2. North Carolina Laws May Allow ESC to Apply Predecessor's Tax Rate to Successor. Where there is a transfer of the assets of the first employer to a second employer, the second employer may "get stuck" with the ESC experience rating of the former employer unless (1) there is a "break-in-service" or (2) unless for some other reason the ESC decides not to force the new employer to assume the SUTA experience rate of the first employer. More often, however, the ESC relies upon the "break-in-service" test. Unfortunately, the statutes do not clarify those situations in which there is a "break-in-service," between the former employer and new employer.

a. Determining an Employer's Unemployment Tax Rate. N.C.G.S. 96-9 defines the rate of contributions required of an employer. N.C.G.S. 96-9(b)(2) sets forth the rules for establishing an experience rating for each company each year. N.C.G.S. 96-9(b)(2)b and c. define "credit ratios" and "debit ratios." A credit ratio is an employer's "credit balance" divided by total taxable payroll for 36 previous months. Likewise, the "debit ratio" is defined as the debit balance divided by the employer's wages for the last 36 months. And, again, the "debit balance" is defined as the excess of benefits paid from an employer's account over the amount of contributions to that account. N.C.G.S. 96-9(b)(2)c.

Next, we then go to "rate charts" set forth set forth in N.C.G.S. 96-9(b)(3)e which provides for the assigned ESC tax rate based upon the debit ratio. Where a debit balance exists for the employer, the assigned rate starts at 2.9% and rises as high as 5.7% depending upon how high the debit ratio is. So, as you can see, although the debit balance of an employer is not necessarily shown as a liability for financial reporting purposes, the existence of a debit balance will cause the employer to incur larger unemployment taxes down the road.

b. Employer's Separate Accounts. N.C.G.S. 96-9(c) sets forth the rules for establishing separate accounts for each employer. N.C.G.S. 96-9(c)(1) provides that the employer shall be credited with 80% of all voluntary contributions. However, under N.C.G.S. 96-9(c)(2), the employer gets charged 120% of any benefits paid out of an account.

c. Definition of "Employer." N.C.G.S. 96-8(5) defines who is an "employer" subject to the ESC rules. Section 96-8(5)b identifies when a successor acquiring company will be deemed to be an "employer" of the prior business. Here is the text of 96-8(5)(b) which defines an "employer" to include:

> Any employing unit **which acquired the organization, trade or business, or substantially all the assets thereof, of another** which at the time of such acquisition was an employer subject to this Chapter, or which acquired **a part of the organization, trade, or business of another**, which at the time of such acquisition was an employer subject to this Chapter; provided, such other would have been an employer under paragraph a of this subdivision if such part had constituted its entire organization, trade, or business; provided further, that G.S. 96-10, subsection (d), shall not be applicable to an individual or employing unit acquiring such part of the organization, trade or business. The provisions of G.S. 96-11(a) to the contrary notwithstanding, any employing unit which becomes an employer solely by virtue of the provisions of this paragraph shall not be liable for contributions based on wages paid or payable to individuals with respect to employment performed by such individuals for such employing unit prior to the date of acquisition of the organization, trade, business, or a part thereof as specified herein, or substantially all the assets of another, which at the time of such acquisition was an employer subject to this Chapter. This provision shall not be applicable with respect to any employing unit which is an employer by reason of any other provision of this Chapter. A successor by total acquisition under the provisions of this paragraph may be relieved from coverage hereunder by making written application with the Commission within 60 days from the date the Commission mails him a notification of his liability and provided the Commission finds the predecessor was an employer at the time of such acquisition only because such predecessor had failed to make application for termination of coverage as provided in G.S. 96-11 of this Chapter. A successor under the provisions of this paragraph who becomes an employer by virtue of having acquired a part of the organization, trade or business of the predecessor hereunder may be relieved from coverage upon making written application with the Commission within 60 days from the date the Commission mails him a notification of his liability and the Commission finds that the predecessor could

have terminated by making the application under G.S. 96-11 if the part acquired had constituted all of the predecessor's business.

This section seems to mandate that purchaser will become a successor employer (1) unless the successor employer files an application with the ESC to not be deemed to be a successor employer or (2) unless there is some "break in service". Generally, this application must be filed within sixty (60) days from the date that the ESC mails the purchaser a notification of its liability.

d. Transfer of Accounts. N.C.G.S. 96-9(c)(4)a. provides that a successor, who acquires all or part of a business and becomes a successor employer (as defined in Section 96-8(5)b discussed above), will normally secede to the account of the transferor. However, there will be no transfer of an account where an account has been terminated because the first employer ceases to be an employer pursuant to N.C.G.S. 96-9(c)(5) and N.C.G.S. 96-11(d).

Thus, the N.C.G.S. 96-9(c)(4) transfer of account rules indicate that the successor business secedes to the predecessor's account only where the successor secedes to or acquires all or a part of a predecessor's business as provided in N.C.G.S. 96-8(5)(b). This gets us back to the general definition of a successor employer.

Finally, N.C.G.S. 96-9(4)c. provides that where an organization or insolvent debtor is taken over and operated by an administrator, receiver, trustee in bankruptcy, the successor shall automatically secede to the account and rate of contribution of the insolvent debtor.

e. The "Blended" ESC Tax Rate. In effect, a "Blended ESC Tax Rate" may apply to an asset purchase where employees of the seller go to work for the purchaser.

f. Break in Service Concept for Predecessor Employers Who Cease To Be Engaged in Business. N.C.G.S. 96-8(5)d defines an employer as someone who has not ceased to be an employer under the provisions of 96-11. 96-11 allows an employer to voluntarily terminate coverage under the Employment Security Fund. Also, N.C.G.S. 96-8(5)f provides that an employer shall cease to be subject to the ESC rules during any calendar year if the Commission finds that the employer was not subject to the federal Unemployment Tax Act or the North Carolina unemployment tax rules. N.C.G.S. 96-9(c)(5) states that, when an employer **ceases to be an employer**, its account shall be closed for purposes of ESC rules. N.C.G.S. 96-11 provides how an employer may voluntarily terminate coverage under the ESC rules.

C. New ESC Rules Applicable to Purchases of a Business in Bankruptcy. SB 2012 has amended the "transfer of account" rules of N.C.G.S. 96-9(c)(4) to now provide that an employer, who purchases another business in a bankruptcy proceeding, will not automatically be assessed the SUTA tax rate of the predecessor, where there is no common ownership between the predecessor and successor. SB 2012 (August 16, 2006).

Note: **<u>Refunds May be Available for Certain Purchases Through Bankruptcy</u>.** The new N.C.G.S. 96-9(c)(4) is **retroactively** applicable to transactions occurring after August 1, 2003. This means that successor employers, who purchased the business of a predecessor in bankruptcy, may be able to apply for a <u>refund</u> of excess SUTA taxes paid after August 1, 2003.

D. <u>Remember the "Break in Service" Concept</u>. The new amendments to N.C.G.S. 96-9(c)(4) do not alter the "transfer of account" rules of N.C.G.S**.** 96-9(c)(4), as they may apply to any successors <u>outside</u> the context of a bankruptcy proceeding. Thus, these acquirers must navigate the difficult waters of the ESC's "break-in-service" concept for predecessor employers who "cease" to be engaged in business before the business sale.

The ESC generally takes the position that no "break in service" has occurred <u>unless</u> the predecessor employer closes its doors before the sale. This is so regardless of:

- whether the sale is a stock sale or asset sale; and
- whether the newly hired employees of the purchaser are given
- new benefits and compensation
- new job titles
- new job responsibilities

Instead, the "break in service" defense may only be available where there is some layoff of the former employees before the sale or where the seller shuts down business operations before the sale. Also, the purchase must prove that the buyer and seller can show that the seller had some "business purpose" for the layoff before the sale. It is not enough for the buyer to show that the seller's employees merely had a few days off before assuming their new job for the purchaser.

E. <u>Note the Rules for a Purchase of a Part of the Seller's Business</u>. A "partial purchase" is where the seller sells a "distinct and severable portion" of one business and where there is another separate business retained by the seller. In those cases, the ESC may not decide to assess the Seller's rate against the purchaser.

F. <u>Buyer May Be Able To Acquire A Lower Tax Rate Of Seller</u>. If the buyer purchases only part of a business, the buyer may not have to assume the ESC tax rating of seller, but the buyer may elect to do so with the permission of the ESC. This provides the seller the chance to negotiate a higher purchase price between buyer and seller, **as long as** the parties do so with the blessing of the ESC.

G. **<u>Conclusion</u>.** In any business acquisition, you should take the following steps:

(1) Determine the ESC tax rate of the Seller;

(2) Confirm whether there are any unpaid ESC taxes of the Seller;

(3) Secure an indemnity from the Seller;

(4) Try to secure a "break in service" of the former employees of the Seller; and

(5) Consider forcing the Seller to sell its assets through bankruptcy.

PART SEVEN
CHANGES TO TAX CREDITS FOR INDIVIDUALS, CORPORATIONS AND PASS-THROUGHS

I. Corporate William S. Lee Tax Credits Revamped

Note: The following was reproduced from CCH North Carolina Tax Reports No. 692 (September 19, 2006)

A. Introduction. North Carolina Governor Michael Easley has signed legislation that repeals the William S. Lee tax credits against North Carolina personal income tax, corporate income tax, corporation franchise tax, and insurance gross premiums tax and replaces them with more narrowly focused tax credits for jobs creation and investments in business property, generally effective beginning with the 2007 taxable year. However, a taxpayer that signs a letter of commitment with the Department of Commerce prior to 2007, stating the taxpayer's intent to create new jobs or make new investments with respect to machinery and equipment, central office or aircraft facility property, or substantial investments in other real property at a specific site in North Carolina, may claim the current William S. Lee credits during the 2007 taxable year.

The credits to be repealed by this legislation are the credits for creating jobs, investing in central office or aircraft facility property, worker training, investment in machinery and equipment, technology commercialization, substantial investment in other property, and development zone projects for new and expanding businesses.

Taxpayers qualifying for the new credits will no longer be required to elect which tax the credit may be claimed against. Rather, taxpayers may claim the new credits against a combination of the personal income tax, corporate income tax, corporation franchise tax, and/or the insurance gross premiums tax.

B. Eligibility Criteria. As with the current credits, the eligibility criteria for the new credits differ depending upon what development tier the business is located in. However, the new credit structure will be based on a three-tier development zone system rather than the current three-tier enterprise zone system. Also, the criteria utilized to rank the different tiers are changed, and enhanced credits are available to taxpayers located within (1) an urban progress zone, rather than the current development zone, or (2) an agrarian development zone.

The new credits may only be claimed by taxpayers involved in specified industries. The qualifying industries are primarily the same as the current credits, however, the central administrative office category is replaced with a company headquarters category and the data processing and computer services category is replaced with information technology and services category. In addition, the following new industry categories are added: aircraft maintenance and repair, motor sports racing team and motor sports racing facilities, and research and development.

In order to claim one of the new credits taxpayers will still have to provide health insurance, have a good environmental and Occupational Safety and Health Act record, and have no overdue tax debts. In addition, to qualify for one of the new credits taxpayers engaged in a corporate headquarters activity must create 75 jobs within a 24 month period.

Businesses located in a tier one development zone will not be required to satisfy any wage standards to claim the new credits. However, businesses in tier two or two three development zones must satisfy a wage standard of paying an average weekly wage that is at least 110% of the average wage for all insured private employers in North Carolina and 90% of the average wage for all insured private employers in the county. Businesses located in a urban progress zone or agrarian development zone will qualify if they pay an average weekly wage that is at least equal to 90% of the lesser of the average wage for all insured private employers in North Carolina and the average wage for all insured private employers in the county.

C. New Jobs Creation Credit. Taxpayers that meet the conditions outlined above and that create a specified number of new jobs may claim the new jobs creation credit. To qualify, a taxpayer must create the following number of new jobs, depending upon which development tier the taxpayer's business is located in: 15 jobs if the business is located in a development tier three area; 10 jobs if the taxpayer is located in a development tier two area; and five jobs if the taxpayer is located in a development tier one area, urban progress zone, or agrarian growth zone.

The amount of the credit also varies by tier designation: $12,500 for businesses in tier one; $5,000 if located in tier two; and $750 if located in tier three. A taxpayer may claim an additional $1,000 if the business is located in an urban progress zone or an agrarian growth zone, increased to $2,000 if the employee hired is a zone resident or a long-term unemployed worker.

The credit must be taken in four equal installments beginning in the taxable year after the taxable year the new job is created. The credit is contingent upon maintaining the employee in the job for the full four years.

D. Business Property Investment Credit. Taxpayers that meet the eligibility criteria discussed above and that purchase or lease qualified business property and place it in service in North Carolina may claim a credit equal to a percentage of the excess of the eligible investment amount above a specified threshold. The threshold is dependent upon the development tier area in which the business is located as follows: $0 for businesses located in a development tier one area, an urban progress zone, or an agrarian growth zone; $1 million for businesses located in a development tier two area; and $2 million for businesses located in a development tier three area.

The eligible investment amount is the lesser of the (1) cost of the eligible business property or (2) the amount by which the cost of all of the taxpayer's eligible business property that is in service in North carolina on the last day of the taxable year exceeds the cost of all of the taxpayer's eligible business property that was in service in this North Carolina on the last day of the base year. The base year is that year, of the three immediately preceding taxable years, in which the taxpayer had the most eligible business property in service in North Carolina. The percentage of the excess over the eligible investment amount that may be claimed is 7% for businesses located in a tier one area, urban progress zone, or agrarian growth zone; 5% for businesses in a tier two area; and 3% for businesses in a tier three area.

The credit is claimed in four equal installments beginning in the tax year after the tax year in which the property is placed in service.

E. Real Property Investment Credit. A qualified taxpayer that meets the eligibility criteria discussed above and that has purchased or leased real property in a development tier one area that begins to use the property in an eligible business during the taxable year may claim a credit equal to 30% of the eligible investment amount. The eligible investment amount is the lesser of the (1) the cost of the property or (2) the amount by which the cost of all of the taxpayer's real property used in North Carolina on the last day of the taxable year exceeds the cost of all of the taxpayer's real property used in North Carolina on the last day of the base year. The base year is that year, if the three immediately preceding taxable years, in which the taxpayer had the most eligible business property in service in North Carolina. Provisions also address how the cost of leased property is to be calculated.

To qualify for the credit, the North Carolina the Secretary of Commerce must certify that the taxpayer is expected to purchase or lease and use in an eligible business at that establishment within a three-year period at least $10 million of real property and that the establishment that is the subject of the credit will create at least 200 new jobs within two years of the time that the property is first used in an eligible business.

F. Fees. Taxpayers claiming one of the new credits discussed above must file a $500 fee for each type of credit claimed. The fee is due at the time the return is due for the taxable year in which the taxpayer engaged in the activity for which the taxpayer is eligible for a credit.

Ch. 252 (H.B. 2170), Laws 2006, effective as noted above.

G. Summary of Changes to Bill Lee Tax Credits. The new revamped credits are substantially similar to the "old" Bill Lee Credits, with several differences, many of which are taxpayer-friendly.

1. Three New Eligible Businesses. Three new types of businesses are now eligible for the credits:

   - motorsports racing teams
   - motorsports facilities - such as race tracks
   - R&D businesses

2. Old Development Zones Now Replaced with

   - "urban progress" zones
   - agricultural zones

3. New Three (Rather than Five) Tier Zones

New Tier	Old Tier
First Tier	First and Second
Second Tier	Third and Fourth
Third Tier	Fifth

4. New Option to Allocate Tax Credits Against Various Taxes

   - Under "old" rules, taxpayer had to irrevocably elect whether to apply credits to franchise or income tax for all years.

   - Now, taxpayer can allocate credits against all types of taxes from and can do so differently from year to year

5. Tax Credit for Central Administrative Office

   - Old Law - only needed 40 employees
   - New Law - must have 75 employees

6. Wage Standard Regime

   - Tier 1 - no wage standard
   - Tier 2 & 3 - still have a wage standard

7. New Job Credits Only Available if Minimum Jobs Created

   - Tier 1 5 new jobs
   - Tier 2 10 new jobs
   - Tier 3 15 new jobs

II. Tax Credits for Investing in Renewable Energy Property; Ceiling for Nonresidential Property Raised and Sunset Extended.

A. Introduction. A taxpayer who constructs, purchases (as defined in IRC §79), or leases renewable energy property and places it in service in North Carolina during a taxable year is allowed a tax credit equal to **35%** of the **cost of the property**. The tax credit for renewable energy property that serves a single-family dwelling must be taken for the taxable year in which the property is placed in service. The entire tax credit for all other renewable energy property, however, cannot be taken for the taxable year in which it is placed in service, but must be taken in **five equal installments**, beginning with the taxable year in which the property is placed in service N.C.G.S. §105-129.16A.

B. Renewable Energy Property Defined. Renewable energy property is any of the following machinery and equipment **or** real property:

(1) Biomass equipment that uses renewable biomass resources for biofuel production of ethanol, methanol, and biodiesel; anaerobic biogas production of methane utilizing agricultural and animal waste or garbage; or commercial thermal or electrical generation from renewable energy crops or wood waste materials. The term also includes related devices for converting, conditioning, and storing the liquid fuels, gas, and electricity produced with biomass equipment (G.S. §105-15(6)(a)]. Renewable biomass resources are organic matter produced by terrestrial and aquatic plants and animals (e.g. standing vegetation, aquatic crops, forestry and agricultural residues, landfill wastes, and animal wastes [N.C.G.S. §105-129.15(3)];

(2) Hydroelectric generators located at existing dams or in freeflowing waterways, and related devices for water supply and control, and converting, conditioning, and storing the electricity generated [N.C.G.S. §105-129.15(6)(b)]. A hydroelectric generator is a machine that produces electricity by water power or by the friction of water or steam [N.C.G.S. §105-129.15(3)];

(3) Solar energy equipment that uses solar radiation is a substitute for traditional energy for water heating, active space heating and cooling, passive heating, daylighting, generating electricity, distillation, desalination, detoxification, or the production of industrial or commercial process heat. The term also includes related devices necessary for collecting, storing, exchanging, conditioning, or converting solar energy to other useful forms of energy [N.C.G.S. §105-129.15(6)(c)]; or

(4) Wind equipment required to capture and convert wind energy into electricity or mechanical power, and related devices for converting, conditioning, and storing the electricity produced [N.C.G.S. §105-129.15(6)(d)].

C. Cost Defined and Ceiling for Nonresidential Property. Cost is determined by regulations adopted under IRC §1012, subject to the limitation on cost provided in IRC §179. In the case of property the taxpayer leases from another, cost is value as determined under the provisions of N.C.G.S. §105-130.4(j)(2) [N.C.G.S. 105-129.15(2)].

Prior to 2006, a taxpayer was limited to a tax credit of $250,000 per installation for renewable energy property placed in service for nonresidential purposes. N.C.G.S. §105-129.16A(c)(1).

D. New 2006 Change Increases Ceiling for Nonresidential Property. Under new 2006 tax changes, the credit ceiling for renewable energy properly placed in a nonresidential property was raised from $250,000 to $2,500,000. Also, the new 2006 law now provides that the credit sunsets for renewable energy property placed in service on or after January 1, 2011.

(Amended N.C.G.S. 105-129.16A. Effective for taxable years beginning on or after January 1, 2006; SB 1149, s.5, S.L. 05-413.)

III. New Rehabilitation Credits Are Available For Rehabilitated Mill Property.

A. Introduction. New nonrefundable credits, against the North Carolina corporation franchise tax, corporation income tax, personal income tax, and insurance gross premiums tax, are available for a percentage of the qualified costs incurred to rehabilitate historic mill facilities.

B. Credits for Rehabilitated Mill Property: Taxpayers may claim either a credit for expenses incurred in rehabilitating

(1) an "income-producing" mill if they are eligible for the federal rehabilitation credit; or

(2) a "non-income" producing mill property.

C. New Definition of "Mill Property." The new definition of "mill property" also now includes:

(1) any manufacturing facility; and

(2) any warehouse previously used for selling agricultural products.

D. Effective Date of Credits. The credits are effective for taxable years beginning after 2005, and are applicable to eligible sites placed into service after June 30, 2006, and for qualified rehabilitation expenditures and rehabilitation expenses incurred prior to January 1, 2011. Unused credits may be carried over for nine subsequent tax years. A taxpayer that claims a mill rehabilitation credit may not also claim a North Carolina historic rehabilitation credit for the same activity.

1. Credit for Rehabilitated Income Producing Mill Facilities. The credit for rehabilitating an income-producing mill facility is equal to 40% of the expenditures that qualify for the federal rehabilitation credit if the eligible site is located in an enterprise tier one, two, or three area, or 30% of the qualified rehabilitation expenditures if the eligible site is located in an enterprise tier four or five area. The credit may be claimed in the year in which the eligible site is placed into service.

2. Credit for Rehabilitated Non-Income Producing Mill Facility. The credit for rehabilitating a non-income producing mill facility is equal to 40% of the rehabilitation expenses if the site is located in an enterprise tier one, two, or three area. No credit is allowed for a site located in an enterprise their four or five area. Unlike the credit for an income-producing mill rehabilitation, the entire credit for non-income producing mill rehabilitation may not be taken for the taxable year in which the property is placed in service, but must be taken in five (5) equal installments beginning with the taxable year in which the property is placed in service.

E. Other Eligibility Requirements. To be eligible for the credits, the site must be located in North Carolina and

(1) must have been used as a manufacturing facility or for purposes ancillary to manufacturing, as a warehouse for selling agricultural products, or as a public or private utility;
(2) must be a certified historic structure or a State-certified historic structure;
(3) must be at least 80% vacant for a period of at least two years immediately preceding the date the eligibility certification is made; **and**
(4) must have certified rehabilitation costs that exceed **$3 million** for the site as a whole.

Prior to claiming the credit, a taxpayer must receive certification from the North Carolina State Historic Preservation Officer that the site and the costs are eligible for the credit.

F. Allocation of Credit for Pass-Through Entities. A pass-through entity that qualifies for the credits may allocate the credit among any of its owners in its discretion as long as an owner's adjusted basis in the pass-through entity at the end of the taxable year in which the eligible site is placed in service, is at least 40% of the amount of credit allocated to that owner. However, the owner forfeits a portion of the credit if he or she disposes of all or a portion of the owner's interest in the pass-through entity within five years from the date the eligible site is placed in service and the owner's interest in the pass-through entity is reduced to less than two-thirds of the owner's interest in the pass-through entity at the time the eligible site was placed in service.

(Ch. 40 (H.B. 474), Laws 2006, effective for taxable years beginning on or after January 1, 2006, and applicable as noted.)

IV. Qualified Business Venture Tax Credits Carryover Limited to $50,000 Per Year - Regardless of How Many Qualified Business Ventures The Taxpayer Invested In During the Tax Year.

In Secretary of Revenue Decision No. 2006-2 (June 26, 2006), an individual invested in two different partnerships which in turn invested in two qualified business ventures during the same tax year. The taxpayer–partner was allocated over $50,000 in business investment credits from the two different partnerships by virtue of investments made by the partnerships in two different qualified business ventures during the same tax year. The applicable amount of the credit, passed through to the taxpayer-partner during the same tax year, exceeded $50,000 for both partnerships. The taxpayer-partner sought to carry over any unused QBV pass-through credits into succeeding tax years - by taking the position that the $50,000 per year limit did not apply to different investments in different qualified business ventures.

A. Background of QBV Rules. Under N.C.G.S. 105-163.011(b), North Carolina taxpayers, who invest in a qualified business venture ("QBV"), may claim a tax credit equal to 25% of the amount invested in a North Carolina qualified business venture ("QBV"). Pursuant to N.C.G.S. 105-163.011(b)(1), the aggregate amount of the credit allowed to an individual for investments made **"in any one year"** may not exceed $50,000. However, N.C.G.S. 105-163.012(a) allows a carryover of any "unused credit allowed," and the unused QBV tax credit can be claimed for up to five years.

B. Facts of Sec. Rev. Dec. 2006-2. In this case, the taxpayer invested in two partnerships. Each partnership made an investment in a separate QBV during the same tax year. The taxpayer-partner's allocable share of each partnership's investment in the two (2) QBVs was over $50,000 during the year of the investment.

For the 2000 tax year, the taxpayer timely filed his North Carolina individual tax return for 2000 and claimed a tax credit of $84,207 for investments made in qualified business ventures during the previous 1999 tax year. The taxpayer, of course, was limited on the return to a credit of $50,000. The taxpayer then filed his 2001 tax return, and carried over the qualified business investment tax credit of $34,000 to the 2001 tax year. Additional unused QBV credits were claimed for 2002.

In this case, the taxpayer argued that the "$50,000 per year limitation" did not apply to an aggregate of all investments in any one year. Instead, the taxpayer argued that all investments for one year should be aggregated and that any unused credit above $50,000 should be carried forward to future years.

C. Secretary of Revenue Decision: The $50,000 Credit Limitation Applies to All QBV Investments Made During the Same Tax Year.

However, the Secretary of Revenue determined that, by the plain meaning of the statute, the $50,000 aggregate limit applies to all investments made in a single tax year, and so the $50,000 limit is applied to all aggregate investments made during the same tax year.

Thus, the taxpayer was only allowed to carryforward any unavailable tax credits which might be available due to the fact that the taxpayer has less than a $50,000 tax liability in any one year.

Note: This case illustrates that, when advising our clients, it might be important to advise our clients to "spread out" their investments in QBVs among two or more tax years. In this case, the taxpayer-partner invested in multiple QBVs during the same year. Thus, the taxpayer was stuck with the $50,000 credit limitation for all investments made during this same (1999) tax year. In this case, if the taxpayer had spread his QBV investments among multiple tax years (say for example 2000 and 2001), the taxpayer would have been allowed to claim the full amount of the credit for those multiple years and would have been allowed to carry forward (for five years) any unused credits.

PART EIGHT
TAX COLLECTION PROCEDURE: AUDITS, STATUTES OF LIMITATION AND NORTH CAROLINA DEPARTMENT OF REVENUE COLLECTION PROCEDURES

I. Corporate Annual Report Fees Modified

Effective September 1, 2007, and applicable to annual reports filed on or after that date, the fee for delivering an annual report (paper) to the Secretary for filing is increased from $20 to $25, and the fee for delivering an annual report (electronic) to the Secretary for filing is $18.

CH. 323 (H.B. 1473) (2007).

II. 2007 New Procedure for Department of Revenue Appeals

A. Background and Summary of Pre-2008 Appeals Rules. We all have suffered frustration in dealing with the North Carolina Department of Revenue appeals procedure. First, there is the fact that, when a taxpayer receives a Notice of Proposed Tax Assessment, the taxpayer has to appeal to the Secretary of Revenue within 30 days. If the taxpayer fails to file an appeal within the 30 day period, the tax assessment becomes final.

Once the 30 day appeal deadline expires, the only recourse for the taxpayer is to pay the tax and then to sue for a refund. Of course, this is very frustrating, since taxpayers often miss the 30 day appeal deadline.

Also, in those rare cases when the taxpayer meets the 30 day appeal deadline, the appeals process is oftentimes less than fruitful. All appeals cases are heard by the Secretary of Revenue, and many taxpayers believe that the Secretary of Revenue rarely rules in favor of the taxpayer.

The other problem with the Secretary of Revenue appeals process is that there is very little case law or authority upon which to rely. The Secretary of Revenue does not publish all of its Rulings. Indeed, when the Secretary of Revenue issues its published Secretary of Revenue Decisions, virtually all of the published decisions are unfavorable to the taxpayer. Anecdotal evidence indicates that of the last 150 Secretary of Revenue decisions which were published, over 140 of them were unfavorable to the taxpayer. This means that there is only a very small body of law which is favorable to the taxpayer.

B. **New Department of Revenue Appeal Procedures Applicable After 2007.** Under Senate Bill 242, we now have a new appeals process. Under the new Section 105-241.11, a taxpayer, who wishes to appeal a proposed tax assessment, now has 45 days to request a review by the Department of Revenue. If the taxpayer requests a review of the tax assessment, then under new Section 105-241.13, the Department of Revenue now must conduct a "review" of the proposed tax assessment, and then must take one of the following actions:

(1) remove the tax assessment;
(2) schedule a conference with the taxpayer; or
(3) request additional information from the taxpayer concerning the proposed assessment.

The taxpayer conference is designed to be an informal proceeding in which the taxpayer and the Department must attempt to resolve the tax case (Section 105-241.13(b)). After the taxpayer conference, if the Department of Revenue and the taxpayer are unable to resolve the case, then the Department must then send to the taxpayer a Notice of Final Determination concerning the assessment. Section 105-241.14. Then, if the taxpayer still disagrees with the Notice of Final Determination, the taxpayer may file a Petition for a Contested Case Hearing at the Office of Administrative Hearings, which is a separate administrative body outside the Department of Revenue. The OAH replaces the Tax Review Board. The taxpayer does not have to pay the tax assessment before filing a Petition to the Office of Administrative Hearings.

The Office of Administrative Hearings then must review the taxpayer's case and, if the taxpayer loses at that stage and wants to appeal further, he then has to proceed to the Court of Appeals - of course, after paying the tax.

III. Erroneous Verbal Advice from NCDOR Representative Does Not Preclude Assessment of Additional Sales Tax; Secretary of Revenue Decision 2004-350 (October 28, 2005)

In Secretary of Revenue Decision 2004-350 (October 28, 2005), the taxpayer was a sports bar restaurant owner which sold prepared foods, liquor and beer at the restaurant. During a sales tax audit, the taxpayer alleged that he had received "verbal advice" from a NCDOR representative that certain restaurant sales were not subject to the increased rate of North Carolina local sales and use tax.

According to the Secretary of Revenue, however, North Carolina is not estopped from collecting sales or use tax when an agent provides erroneous verbal advice, since the taxpayer did not request a **written ruling** from the Department of Revenue, and therefore the sales tax assessment was appropriate and upheld. In fact, the provisions of N.C.G.S. 105-264 only provide taxpayers with protection from assessment of additional tax where erroneous advice is given **in writing** in response to taxpayer's **written request**, and where the taxpayer furnishes adequate and accurate information to the Department upon which the advice is based.

IV. Extended Filing Due Date Starts the Limitation Period for Filing a Refund Claim or for Additional Tax Assessments.

In October 2006, the Department of Revenue issued a directive [Directive No. CD-06-01 (CCH 202-359)] which provides additional guidance on when the statute of limitations period for filing a refund claim or proposing an assessment of North Carolina corporate or personal income taxes starts. According to the Directive, the statute of limitations for filing a refund claim or for proposing an additional assessment of North Carolina corporation income tax, franchise taxes or personal income taxes commences with the due date of filing a return, including extensions. Because extensions are statutorily authorized, in instances when the taxpayers request a filing extension, the extended filing date is the date on which the statute of limitations period commences.

Note: This Directive also provides several examples to illustrate how these rules operate.

V. Protective Claim for Refund Procedures Announced.

A. General Overview. A protective refund claim is a claim filed to protect a taxpayer's rights to a potential refund based on a contingent event for a tax period for which the statute of limitations is about to expire.

B. North Carolina Department of Revenue Announces How To Perfect a Protective Refund Claim. A protective claim for a refund is usually based on contingencies such as (1) pending litigation, or (2) an ongoing income tax audit in another state. In North Carolina Department of Revenue Press Release (January 5, 2006), the Department of Revenue explained how you can claim a **"protective refund claim"** for a taxable period for which the statute of limitations is about to expire.

The Department of Revenue advises that there is no special form for filing a protective claim for a refund. Instead, the Department of Revenue will accept **any written submission**, provided that the written submission contains all the required elements for a protective refund claim (as described below). Once the contingency has been concluded, the taxpayer **may perfect** the refund claim by filing an **amended return** for the tax year at issue.

Generally, the Department of Revenue will accept a protective claim for a refund provided that the claim: (1) is filed before the expiration of the statutory refund statutes of limitations period; (2) identifies and describes the contingencies affecting the refund claim; (3) is sufficiently clear and definite to alert the Department of Revenue as to the essential nature of the claim; and (4) identifies the tax schedule and the specific year for which the protective claim is filed.

C. Refunds For Years Under IRS Examination. It is not necessary for a taxpayer to file a North Carolina protective refund claim for income tax purposes for a year under examination by the IRS. This is because, under North Carolina law, a taxpayer has six months after being notified of the federal changes to file an amended North Carolina tax return to report the changes.

VI. New Time Limits for Filing Corrected Individual or Corporate Income and Gift Tax Returns After Additional Federal Assessments.

House Bill 1892 has amended several different corporate income tax, individual income tax, and individual gift tax provisions pertaining to the requirement to file amended North Carolina returns to correct for a federal redetermination made after June 30, 2006. Under House Bill 1892, N.C.G.S. 105-130.20 and N.C.G.S. 105-159 have been amended to provide that taxpayers will no longer have two (2) years to file corrected income or gift tax returns after a federal redetermination of the taxpayer's taxable income or net taxable gifts. Now, taxpayers will only have six (6) months to file corrected returns with the NCDOR.

If the taxpayer fails to file amended returns within six (6) months, the taxpayer will forfeit any refunds due by reason of the redetermination. And, watch out for the "failure to file" penalty!

Note: The new rules apply to federal redeterminations made by the IRS after June 30, 2006.

VII. Project "Collect Tax": Continued Outsourcing of Tax Collection Efforts.

Senate Bill 353 authorized the Department of Revenue to hire private independent contractors to collect overdue tax debts of both resident and non-resident taxpayers. Under "Project Collect Tax," the Department of Revenue now imposes a new 20% collection assistance fee on an overdue debt that remains unpaid thirty (30) days after the fee notice is mailed to the taxpayer. The fee notice must state that the fee will be imposed if the tax debt is not paid within thirty (30) days after the date that the fee notice was mailed.

At least thirty days before submitting the tax debt to a private contractor, the Department of Revenue must notify the taxpayer by mail that the debt may be submitted for collection if payment is not received within thirty days after the date that the notice was mailed. Thus, taxpayers will have thirty days after receiving the notice to make full payment or else risk being assessed an additional 20% collection fee.

Senate Bill 236 (Session Law 2003-349) enacted on July 27, 2003 extends the Department of Revenue's authority to continue outside collection agencies until October 1, 2005. Senate Bill 622 (2005) extends the Department of Revenue's use of outsourcing to collect unpaid North Carolina taxes.

NOTE: For more information concerning the 20% Collection Assistance Fee, see the "Frequently Asked Question" section of the North Carolina Department of Revenue website.

VIII. "Project Collect Tax" Surpasses its Goals.

In August 2001, Governor Easley launched "Project Collect Tax" and set a goal for collecting $150,000,000 of delinquent tax. During its first two years, the Department of Revenue collected $187,500,000 in back taxes through its Project Collect Tax initiative, surpassing its internal goal by $37,500,000.`

The North Carolina Department of Revenue estimates that Project Collect Tax generated $189 Million of revenues during the 2003-2004 fiscal year, up from $111 Million in revenues during the 2002-2003 fiscal year. Thus, all totaled, Project Collect Tax has generated $479 Million of collected taxes.

IX. Beware of Increased Focus on Corporate Non-Filers.

During the week of September 9, 2002, the North Carolina Department of Revenue sent out a series of inquiries to corporations which are qualified to do business in North Carolina, but for which no recent tax returns have been filed. We understand that these inquiries look back as far as the 1994 tax year. The purpose of these inquiry letters is to determine if any corporations have been ignoring their North Carolina filing obligations. Be prepared to hear more about this from your clients.

X. Increased Focus on Tax Protestors and Non-Filers.

In an effort to increase the collection of revenue, the North Carolina Department of Revenue is focusing heavily upon tax protestors and non-filers and fraudulent tax return preparers. We understand that there has been a resurgence in the number of tax protestors who are filing fraudulent tax returns or perhaps filing no tax return at all. The Department of Revenue has several means of locating these "tax protestors."

First of all, under the IRS cooperative matching system, when the IRS discovers a taxpayer who has not filed his or her individual federal income tax return, the IRS will also notify the Department of Revenue of the non-filed federal tax return.

Other taxpayers are more creative in attempting to evade North Carolina taxation. Some taxpayers file tax returns, but instead report zeros throughout their entire tax return, except to the extent of their income tax withholdings. Fortunately, the North Carolina Department of Revenue computer system automatically "kicks out" any returns showing zero federal taxable income.

Other taxpayers attempt to evade North Carolina income taxation by filing fraudulent Forms NC-4 to report excessive withholding exemptions to prevent their employers from withholding any income tax on periodic pay checks. However, under North Carolina law, employers are required to notify the North Carolina Department of Revenue if a Form NC-4 shows nine (9) or more withholding exemptions for that taxpayer.

XI. North Carolina Department of Revenue Launches "Project Compliance."

On the heels of the success of "Project Collect Tax," Governor Easley has launched a new audit initiative for the Department of Revenue called "Project Compliance." This new audit initiative challenges the Department of Revenue to collect over $100,000,000 of additional tax revenue in the next two years through the addition of thirty-nine new North Carolina Department of Revenue audit agents.

Based upon our **informal discussions** with North Carolina Department of Revenue officials (and based upon our recent experiences), we understand that North Carolina Department of Revenue auditors will focus increased audit attention on the following:

1. Bill Lee tax credits;

2. Business entities that fail to file North Carolina returns;

3. Business entities that create out-of-state intangible asset holding companies;

4. Business entities that use affiliated entities to take advantage of transfer pricing arrangements (IRC Section 482);

5. Taxpayers engaged in “income shifting strategies” and transactions by using affiliates and subsidiaries to shift income and transactions outside of North Carolina in transactions which have no independent business purpose other than the avoidance of North Carolina taxation, such as the following:

    a. Procurement companies;
    b. Management companies;
    c. Factoring companies; and
    d. Intellectual property companies.

6. Use of affiliates to manipulate North Carolina apportionment factors with out-of-state sham entities - See 5 above;

7. Targeting non-filers and tax protestors and assisting tax return preparers, including criminal prosecution (See North Carolina Department of Revenue Press Release dated September 22, 2005 - North Carolina attorneys sentenced to 45 day prison terms for failure to file North Carolina tax returns);

8. Taxpayers who file fraudulent NC-4s withholding certificates claiming nine withholding exemptions;

9. Taxpayers who fail to file Form 1099-NRS. Few of us may be aware that an out-of-state resident, who sells North Carolina real property, is liable for North Carolina tax on the sale of the real property. In 1992, the Department of Revenue created Form 1099-NRS and requires that buyers issue a Form 1099-NRS to an out-of-state seller of North Carolina real property. The Department of Revenue has concluded that many purchasers of North Carolina real estate are failing to issue a Form 1099-NRS to out-of-state sellers of North Carolina real property. Under Project Compliance, the Department of Revenue will continue to pay increased audit attention focus on out-of-state sellers of North Carolina real estate;

10. Individual income taxpayers who do not report the full amount of use tax on out-of-state purchases;

11. Increased audit focus on Federal Schedule A and Schedule C items. This initiative will focus on fraudulent Schedule A itemized deductions (such as charitable contributions and employee business expenses);

12. Increased audit focus on Federal Schedule C business expense items (such as home office deduction items and "not-for-profit" activities) claimed for federal tax purposes;

13. Increased audit focus on Conservation Easement Donations;

14. Increased focus on “Guest Workers” who file fraudulent NC-4s withholding certificates claiming nine withholding exemptions or who claim they are independent contractors (and who therefore receive Form 1099 rather than Form W-2);

15. Increased audit focus (including criminal tax evasion charges) against North Carolina domiciled individual taxpayers who claim they are

residents of another state;

16. Increased Audit Attention on Off-Shore Tax Shelters - through a joint participation effort with IRS;

17. Qualified Business Venture Tax Credits - additional focus on (a) investor-employees, (b) investors who fail to file their QBV Credit Applications by the April 15 due date and (c) some fictitious businesses as well; and

18. Criminal Prosecution of Responsible Persons Who Fail to Pay Collected Sales Taxes and Withholdings Taxes. (See North Carolina Department or Revenue Press Release dated January 5, 2005 - 30 day active jail sentence for business owner who failed to remit $14,000 of collected sales taxes - aiding and abetting the embezzlement of North Carolina and county sales taxes).

XII. North Carolina Volunteer Disclosure Program Revised in 2007.

A. Background. The North Carolina Volunteer Disclosure Program is designed to promote compliance and to benefit taxpayers who discover a past filing obligation and liability that has not been discharged. It applies to taxpayers who have failed to file returns and pay any tax due to the North Carolina Department of Revenue. It also applies to any tax administered by the North Carolina Department of Revenue, as well as any type of domestic or foreign taxpayer who is subject to tax in North Carolina.

However, this program is not available to corporate and individual income taxpayers who have engaged in income shifting tax strategies or other tax shelter activities that minimize or eliminate North Carolina state taxes. Also, the voluntary disclosure program does not apply to any taxpayer who is registered for payment of the tax but fails to file a return (ex. sales or employment tax returns), and it does not apply to a taxpayer who files a return but under reports tax due on the return.

Voluntary disclosure arises when a taxpayer contacts the North Carolina Department of Revenue without any prior initial contact by the North Carolina Department of Revenue concerning the filing of a return and the payment of a tax. Voluntary disclosure includes requests by taxpayers under the Multistate Tax Commission National Nexus Program. A major component of the Voluntary Disclosure Program is to resolve sales and use tax, and corporate income and franchise tax liabilities when nexus is the central issue.

B. **<u>Summary of Voluntary Disclosure Program</u>.** Here is a summary of the new Voluntary Disclosure Program taken from the North Carolina Department of Revenue website:

<u>Description of Program</u>

The North Carolina Voluntary Disclosure Program is designed to promote compliance and to benefit taxpayers who discover a past filing obligation and liability that have not been discharged. **This program is not available to corporate and individual income taxpayers who have engaged in income shifting tax strategies or other tax shelter activities that minimize or eliminate North Carolina state taxes.** It applies to taxpayers that have failed to file returns and pay any taxes due to the Department. It applies to any tax administered by the Department and to any type of domestic or foreign taxpayer that is subject to tax in this State. Voluntary disclosure does not apply to a taxpayer that is registered for payment of a tax but fails to file a return. It does not apply to a taxpayer that files a return but under reports the tax due on the return. This program is also not available to taxpayers that have been suspended by the Secretary of State per G.S. 105-230 and subject to reinstatement under G.S. 105-232.

Voluntary disclosure arises when a taxpayer contacts the Department without any prior initial contact by the Department concerning the filing of a return and the payment of a tax. Voluntary disclosure includes requests by taxpayers under the Multistate Tax Commission National Nexus Program. A major component of the Voluntary Disclosure Program is to resolve sales and use, and corporate income and franchise tax liabilities when nexus is the central issue.

I. Qualifying for Voluntary Disclosure

For a disclosure by a taxpayer to be voluntary, it must meet all of the following criteria:

1. The Department of Revenue has not contacted the taxpayer with respect to any tax for which the taxpayer is requesting voluntary disclosure.

2. The taxpayer does not have outstanding liabilities for other taxes.

3. The taxpayer is not under audit for any tax.

4. The taxpayer was never previously registered for the tax schedule being disclosed.

5. The taxpayer has never filed a return with the Department for the tax schedule being disclosed.

6. The taxpayer pays the tax due plus accrued interest. Upon request, the Department will calculate the interest due and notify the taxpayer.

7. Upon request, the taxpayer makes records available for audit to verify the amount

of the taxpayer’s liability and the accuracy of the representations made by the taxpayer.

8. Subsequent to the disclosure, the taxpayer will remain in compliance for all tax schedules.

II. Benefits of Voluntary Disclosure

A taxpayer whose application for a voluntary disclosure is approved will receive:

1. Waiver of civil penalties and an agreement by the Department to not pursue criminal prosecution unless the taxpayer collected a trust tax but did not pay it to the Department. If trust taxes were collected, the Department will waive all civil penalties except the 10% civil penalty for failure to pay the tax when due. In the absence of fraud, the Department will not pursue criminal prosecution. Please note that effective July 1, 2005, G.S. 105-163.15 and G.S. 105-163.41 were amended to define the Underpayment of Estimated Tax Penalty as interest, and the statutes have no provision for the waiver of interest.

2. When applicable, the ability to file the liability in a spreadsheet format versus filing a return for each period involved. The spreadsheets must reflect liability in chronological order.

3. Sixty (60) days to determine the liability and prepare the returns or spreadsheets.

4. A requirement to pay all tax due for the look-back period. The look-back period is four delinquent years for annual filers or forty-eight months for taxes that do not have an annual filing frequency. If the applicant has collected taxes and not reported them for periods beyond the look-back period, the look-back period will be extended to cover those periods.

   The look-back period for voluntary disclosure is shorter than the look-back period that applies when the Department discovers through examination that a taxpayer has failed to file returns and pay taxes due. The look-back period for taxpayers discovered through examination is six years for annual filers or seventy-two months for taxes that do not have an annual filing frequency.

III. How to Apply

A request for a voluntary disclosure must be in writing and addressed to the following:

Voluntary Disclosure Program
North Carolina Department of Revenue
P. O. Box 871
Raleigh, North Carolina 27602-0871

IV. Information to Be Submitted with Request

A. Business Taxes

The taxpayer or a representative of the taxpayer initiates contact with the Department of Revenue by writing a letter describing all of the following:

1. The taxpayer's business.

2. The nature and extent of the taxpayer's activities in North Carolina, including whether the taxpayer does any of the following:

   a. Owns or leases property in the State
   b. Has employees or independent sales representatives soliciting sales in the State.
   c. Has inventory located in the State.
   d. Makes deliveries into the State and, if so, the means of transportation used.
   e. Engages third parties to install or repair property sold to North Carolina customers.
   f. Engages in other activities described in 17 NCAC 5C .0102 or in G.S. 105-164.3(5) or 105-164.8(b).

3. The length of time the taxpayer has been in business and the period of time it conducted activities in North Carolina.

4. The taxpayer's previous filing or payment history with the Department.

5. Whether the taxpayer has been contacted by the North Carolina Department of Revenue or the Multistate Tax Commission regarding its liability.

6. Whether the taxpayer has any outstanding liabilities for any tax administered by the Department.

7. An explanation of why returns were not filed and taxes paid.

B. Personal Taxes

A representative of the taxpayer or the taxpayer initiates contact with the Department of Revenue by writing a letter explaining why returns were not filed and taxes paid. Personal taxes do not include withholding taxes.

V. Review and Approval of Voluntary Disclosure Requests

An application will not be considered until a full written disclosure has been submitted to the Department. Based on the information submitted, the application will be approved, rejected, or a counter proposal made. Once the application has been approved, unless a letter is more appropriate, the Department will sign a Voluntary Disclosure Agreement and send it to the taxpayer or representative of the taxpayer for proper signatures.

Upon receipt of the properly signed Voluntary Disclosure Agreement, the Department will determine whether the taxpayer has an outstanding liability for any tax, a prior filing history, or previous contact with the Department. Any returns and payments received will be processed and an account will be established.

If the Department determines that the taxpayer or its representative misrepresented the information upon which the Agreement is based, the Agreement can be voided and the Department can take action as if the Agreement does not exist.

VI. Audits for Voluntary Disclosure Period

The Department reserves its right to audit a taxpayer’s books and records, subject to the time limits set out in G.S. 105-241.1. The audit may include all or part of a voluntary disclosure period. The Department will assess any tax determined to be due that was not discharged under the Voluntary Disclosure Agreement. All applicable penalties and interest will apply to additional taxes discovered to be due that have not been paid.

VII. Confidentiality

The Department will not release the identity of a taxpayer that enters into a Voluntary Disclosure Agreement or the terms of the Agreement unless the information must be released upon request under the provisions of G.S. 105-259 or existing information exchange agreements.

VIII. Any Questions?

Please contact Discovery & Special Projects toll-free at 1-877-919-1819 ext. 10215, or email Sanda.Hartigan@dornc.com

C. **<u>Observation</u>:** If the taxpayer has not registered for the payment of a trust fund tax (income tax withholdings or sales tax), but comes forward with voluntary disclosure of unpaid trust fund taxes, the North Carolina Department of Revenue will agree to forego criminal prosecution. On the other hand, if the taxpayer has registered for a trust fund tax, but fails to pay the tax and then comes forward with a voluntary disclosure, the Department of Revenue will **not agree** to forestall criminal prosecution in that case. According to the Department of Revenue, the reason for the disparate treatment of these two individuals is that, in the first case, the Department of Revenue did not even know that the taxpayer existed (and therefore would not have been able to track him down to collect the delinquent revenue but for his coming forward), but in the second case, the Department of Revenue believes that it ultimately would have located the delinquent taxpayer and would have collected the unpaid revenue in due course.

XIII. <u>Offers in Compromise and Installment Payment Agreements</u>.

A. **<u>Installment Payment Agreements</u>.** N.C.G.S. 105-237(b) authorizes the North Carolina Department of Revenue to enter into an installment payment agreement if the Department determines that the agreement will facilitate payment of the tax. The agreement may also include a waiver of penalties, but interest cannot be waived.

Please note that the provisions of N.C.G.S. 105-237 do not specifically enumerate how the Department of Revenue is to establish the monthly installment payment amount. In contrast, as we all know, the IRS has very strict guidelines it must follow in order to determine the monthly payment amount.

B. **<u>Offers in Compromise</u>.** N.C.G.S. 105-237.1(a) allows the North Carolina Department of Revenue to accept a lesser amount (of tax, interest and penalties) in full satisfaction of the taxpayer's total North Carolina liability if the Department of Revenue determines that the "compromised settlement" is in the best interest of the state. However, a compromise settlement may only be made if **one or more** of the following findings is made:

(1) there is reasonable doubt as to the **amount of the liability** of the taxpayer;

(2) the **taxpayer is insolvent** and thus, the Department could not collect an amount in excess of the amount offered in compromise;

(3) **collection of a greater amount than that offered is improbable** and the funds offered come from sources from which the Department of Revenue could not otherwise collect;

(4) **a federal tax assessment** arising out of the same facts **has been compromised** with the IRS and the Department of Revenue could not collect an amount equal to or more than that offered by the taxpayer.

C. Tax Advisors Should Consider OICs and Installment Payment Arrangements. Tax practitioners have been accustomed to attempting to negotiate Offers in Compromise and Installment Payment Agreements with the Internal Revenue Service. Often, however, tax practitioners overlook the possibility of installment payment agreements or Offers In Compromise with the North Carolina Department of Revenue. In many cases, it may actually be easier to secure favorable collections treatment when representing clients before the North Carolina Department of Revenue than it is when representing clients before the Internal Revenue Service.

As we all have experienced in the past, before the IRS will even consider an Offer In Compromise or Installment Payment Agreement, the taxpayer must meet rigorous tests. In essence the IRS will only accept an installment payment agreement or an Offer In Compromise in those cases where the particular financial circumstances of the taxpayer demonstrate a situation in which the IRS (but not the taxpayer) would be in a better position through an installment payment arrangement or Offer In Compromise. For example, the IRS will usually not consider an Offer In Compromise or installment payment arrangement in those situations where the IRS could collect more money simply by seizing the taxpayers assets or garnishing future wages.

In contrast, the North Carolina Department of Revenue has more limited seizure authority. Furthermore, IRS tax liens generally are superior to North Carolina Department of Revenue tax liens. Therefore, from a collection standpoint, the North Carolina Department of Revenue is in a much weaker collection position than is the IRS.

Moreover, whereas Internal Revenue Service collection officers are required to follow certain IRS guidelines, the North Carolina Department of Revenue collection agents are not bound by any specific standards or collection guidelines. Thus, collection officers are given much wider latitude to review Offers In Compromise and installment payment arrangements (although we understand that the Department of Revenue is not very receptive to Offers in Compromise involving installment payments over more than six months).

Also, there is no specific Offer In Compromise specialist within the North Carolina Department of Revenue. Instead, individual collection officers review Offers In Compromise and installment payment arrangements. This means that you can generally deal with the same North Carolina collections officer (to negotiate an OIC or an installment payment arrangement) that you have been dealing with for collection purposes. Once the local collections officer has reviewed the OIC, the local collections officer will forward his/her recommendation to the OIC Review Committee for approval. If the OIC Review Committee concurs with the recommendation of the local collections officer, the OIC is submitted to the Secretary of the Department of Revenue and Attorney General. As a matter of internal policy, the Department tries to process OIC's within 90 days of submission!

Thus, the Offer In Compromise and installment payment arrangement process may also be much more efficient with the North Carolina Department of Revenue.

Offers In Compromise, for North Carolina tax purposes, can be made by submitting Form Gen. 74. To request an installment payment arrangement, no specific form needs to be submitted to the North Carolina Department of Revenue.

XIV. Innocent Spouse Relief Available for North Carolina Purposes.

Under I.R.C. Section 6015, innocent spouse relief is available to certain "innocent" spouses. Under N.C.G.S. 105-G152(e), if a taxpayer receives innocent spouse treatment for federal tax purposes, this innocent spouse is also automatically eligible for innocent spouse relief for North Carolina income tax purposes. This innocent spouse relief provision under North Carolina law has become more significant in the last couple of tax years as the result of the expansion of federal innocent spouse relief tax rules.

If you have a client who has received innocent spouse treatment from the Internal Revenue Service, you should submit a request to the North Carolina Individual Income Tax Division in Raleigh (or to the Revenue Collection Officer assigned to the collection case) to receive comparative relief from North Carolina tax liabilities.

Moreover, we also understand that, if a taxpayer has filed an innocent spouse relief request with the IRS, then the North Carolina Department of Revenue will automatically suspend any further collection efforts pending resolution of the IRS innocent spouse relief application.

XV. North Carolina Penalty Waiver Policy Revised in 2007.

A. Penalty Waiver Policy. The North Carolina General Statutes require the Department of Revenue to impose certain civil penalties on taxpayers who do not comply with tax laws. The most frequently-applied penalties are the "core" penalties. The core penalties are

- the failure to file penalty,
- the failure to pay penalty,
- the negligence penalty, and
- the underpayment of estimated tax penalties.

In certain circumstances, the Secretary of Revenue has the authority to waive or reduce all of these penalties.

In 1999, the North Carolina Department of Revenue adopted a new penalty waiver policy applicable to all of the core penalties that are pending on April 1, 1999, or that are assessed on or after that date. In March 2007, the Department issued a new revised Penalty Waiver Policy. The following is the new waiver policy as provided in North Carolina Department of Revenue Penalty Waiver Policy Memorandum (March 2, 2007).

I. Introduction.

This document describes the penalty waiver policy of the North Carolina Department of Revenue and supersedes all prior documents. It applies to requests for waiver of civil penalties considered by the Department on or after March 1, 2007. The North Carolina General Statutes require the Department of Revenue to impose certain civil penalties on taxpayers who do not comply with the tax laws and give the Secretary of Revenue the authority to waive or reduce all of these penalties.

Civil penalties serve two important purposes. First, they increase voluntary compliance with the tax laws because the prospect of owing more money as a result of a failure to comply provides an incentive for compliance. Second, they promote a fair tax system because they provide the mechanism to treat taxpayers who comply with the law differently than taxpayers who do not comply.

II. The Core Penalties

Various statutes throughout Chapter 105 of the General Statutes establish penalties the Department must assess for noncompliance. The most frequently applied penalties are the core penalties. The core penalties are:

Penalty	Statute
Failure to File	105-236(3)
Failure to Pay	105-236(4)
10% Negligence	105-236(5)a.
25% Negligence for Individual Income Tax	105-236(5)b.
25% Negligence for Taxes Other Than Individual Income Tax	105-236(5)c.

III. Waiver Criteria

Two categories of criteria apply to the waiver of penalties. They are:

A. General Waiver Criteria

- Three Automatic Reasons
- Good Compliance Record Reason

B. Special Circumstances

The category of general waiver criteria consists of three automatic reasons to waive a penalty and one conditional reason of good compliance record. The general waiver criteria apply to the core penalties, with the exceptions noted below.

The category of special circumstances applies in limited circumstances to all penalties, with the exceptions noted below, and consists of all other reasons to waive penalties. It applies to penalties that are subject to the general waiver criteria but not subject to the good compliance record reason. Waiver of a penalty based on the category of special circumstances is the exception rather than the rule.

Exceptions:

- The failure to pay penalty on trust taxes withheld or collected and not remitted.

- Penalties assessed for taxes that are not reported at regularly recurring intervals. Example of taxes that are not reported at regularly recurring intervals include estate tax, gift tax and the unauthorized substances tax. The good compliance record reason in the general waiver criteria does not apply to these taxes because these taxes lack the compliance history that is the basis of the good compliance record reason.

- Penalties assessed as the result of a taxpayer engaging in tax strategies whereby income that would otherwise be taxable in North Carolina is shifted out-of-state or in other tax shelter activities that reduce or eliminate North Carolina state taxes will not be waived for any reason.

IV. General Waiver Criteria

A. Automatic Reasons Under General Waiver Criteria

The three automatic reasons for waiver of a penalty under the general waiver criteria are listed in the chart below. These reasons are considered automatic because if one of them applies, all penalties are waived in their entirety, regardless of the taxpayer's compliance record or current status and the number of penalties that have been waived for that taxpayer in the past.

Automatic Reasons	Waiver Period
Death of the taxpayer, the taxpayer's immediate family member, or the taxpayer's tax preparer.	Three months following the date of death.
Serious, sudden illness of the taxpayer, the taxpayer's immediate family member, or the taxpayer's tax preparer.	Three months following the date the illness began.
Natural disaster, such as a tornado or hurricane, or an accident, such as a fire, that destroyed property, records, or both.	For disasters addressed in a memo from the Secretary or the Governor, the period set in the memo. For other disasters and for accidents, three months from the date of the disaster or accident.

An immediate family member is any of the following:

- A parent, child or a spouse. This applies whether or not the individual lives in the same household as the taxpayer.

- Someone who is not a parent, a child, or a spouse and who lives in the same household as the taxpayer. An individual in this category can be an aunt, a grandparent.

Penalties Subject to Automatic Reasons

Waiver for automatic reason must apply to the facts. For some penalties, automatic reasons are unlikely to be the cause of the action by the taxpayer that resulted in the penalty (for example, bad check or funds transfer penalty, civil fraud, penalty and misuse of a certificate of resale).

B. <u>Good Compliance Record Reason Under General Waiver Criteria</u>.

The good compliance record reason allows every taxpayer one "free penalty pass" for each tax type every three years. Its purpose is to recognize that everyone makes mistakes and sometimes has difficulty complying with the tax laws.

Good compliance record is the one conditional reason within the category of general waiver criteria. It is a conditional reason because the taxpayer must meet six conditions to qualify for a waiver under this reason. One of these conditions involves a "look-back" period.

The "look-back" period is a three-year period that consists of the taxpayer's most recent compliance history. It ends on the date a request for penalty waiver is being considered by the Department and it starts three years before it ends.

The six conditions a taxpayer must meet to qualify for a waiver under the reason of good compliance record are:

(1) *No Tax Returns or Reports Due*: The taxpayer must have filed all tax returns and tax reports due. This condition is not tied to the look-back period or the tax type.

(2) *No Outstanding Liabilities*: The taxpayer must have paid any tax and interest due for the period for which the penalty waiver is requested as well as any amount shown due on a final bill received for a tax period that is different from the tax period for which the

penalty waiver is requested. Outstanding liabilities that are the subject of a hearing do not count; these liabilities are in dispute and have not been final billed. This condition is not tied to the look-back period or the tax type.

(3) *No Prior Waivers*: The taxpayer has received no 100% penalty waiver for that tax type based on good compliance record during the "look-back" period. A waiver during the look-back period based on an automatic reason or on special circumstances does not count. An abatement of a penalty during the look-back period does not count. A penalty is abated when it was imposed in error.

(4) *Not Same Mistake*: The error or practice that gave rise to the penalty is not the same as or similar to one found in a prior audit of the taxpayer. This condition is not tied to the look-back period.

(5) *No Tax Avoidance/Income Shifting*. Penalties are not assessed as the result of a taxpayer engaging in tax strategies whereby income that would otherwise be taxable in North Carolina is shifted out-of-state or in other tax shelter activities that reduce or eliminate North Carolina state taxes.

(6) *Provided All Requested Documentation*: The taxpayer has not been notified in writing that they did not provide all requested documentation and that the file is being so noted.

For a taxpayer who is an individual and is married, both the taxpayer and the taxpayer's spouse must meet the conditions to qualify for waiver under the good compliance record reason if the tax for which the penalty was imposed is a tax for which both spouses are jointly liable. Thus, for spouses who file a joint individual income tax return, both spouses must meet the conditions.

Sometimes a taxpayer is individually liable for one tax, such as sales and use tax, and is jointly liable for another tax, such as individual income tax. For these taxpayers, their compliance record for both their individual liabilities and their joint liabilities must be considered. A taxpayer who files a sales and use tax return late and is assessed failure to file and failure to pay penalties is not eligible for waiver based on good compliance record if the taxpayer has an outstanding income tax liability arising from a joint return filed with the taxpayer's spouse.

V. Action When Taxpayer Has Good Compliance Record

If a taxpayer meets all of the good compliance record conditions, the taxpayer is eligible for waiver of the penalty in its entirety. The taxpayer is eligible for waiver if, during the "look-back" period, the taxpayer has not received a 100% penalty waiver based on a good compliance record for that tax type.

VI. Penalties Grouped for Waiver Under General Waiver Criteria

All penalties that are subject to the general waiver criteria and are assessed for the same filing period are treated as one for purposes of applying the good compliance record reason. Thus, if a taxpayer is assessed failure to file, failure to pay, and the 25% negligence penalty for the same period and the taxpayer has a good compliance record, all three of these penalties would be waived and the waiver of the three would count as one waiver.

The filing period for a tax is the period covered by a return or payment, whichever s shorter, except for audits. For an accelerated withholding taxpayer, for example, a filing period is the period covered by a payment rather than the period covered by the quarterly return. The period of an audit is treated as one filing period, regardless of the number of separate filing periods that occurred during the period of the audit and regardless of whether there are delinquent filing periods in the audit period. Thus, if a sales tax audit that covers a three-year period includes three monthly filing periods for which the taxpayer did not file a return, the three delinquent monthly periods are considered to be part of the one audit period.

If an audit covers more than one tax type, each tax type is a different filing period, with two exceptions. The first exception is for corporate income and franchise taxes. In an audit, corporate income and franchise taxes are treated as one tax type. The second exception is for State sales and use tax, local sales and use tax, and the Mecklenburg public transportation sales and use tax. These three taxes are treated as one tax type for purposes of penalty waivers.

Period grouping is also applicable to taxpayers who voluntarily file original or amended returns for more than one period at the same time. If the taxpayer has been contacted by the Department of Revenue about the tax type, then period grouping does not apply.

VII. Request to Waive Penalties

A taxpayer may request a waiver of penalties in any of the following three ways:

- Submitting Form NC-5500, Request to Waive Penalties
- Writing a letter
- Calling the Department, in limited circumstances

Form NC-5500: This form, Request to Waive Penalties, has been developed for use in administering penalty waiver requests. The form is available by calling our toll-free taxpayer assistance line at 1-877-252-3052 and selecting the menu option for Forms, from any Department of Revenue field office or by accessing the Department's website at http://www.dornc.com. A taxpayer who completes Form NC-5500 must sign the form before it can be processed.

Phone Call: When the request is based on the reason of good compliance record, a request to waive a penalty can be made by telephone.

Letter: A taxpayer may write a letter instead of completing Form NC-5500; however, the letter must contain the same information that is requested on Form NC-5500. The Department can process a request submitted on Form NC-5500 faster than it can process the same request submitted in a letter.

A request to waive a penalty is not a request for an administrative hearing. It therefore does not extend or otherwise affect the requirement that a taxpayer who wants to contest an assessment must make a written request for a hearing or for additional information within 30 days after the date of the assessment.

VIII. Grant or Denial or Request to Waive Penalties

If the Department grants a request for waiver of a penalty, the Department informs the taxpayer of this action either through an amended assessment notice, refund with explanation, or a letter. If the Department denies a request for waiver of a penalty, the Department sends the taxpayer a letter of denial.

A taxpayer may request a review of the denial of a request to waive a penalty. A request for review must be in writing and must explain why the taxpayer's request to waive the penalty should have been granted. A request for review should be sent to the address on the letter of denial.

XVI. Penalties for Underpayment of Estimated Tax Are Interest Charges and Not Penalties.

Under Senate Bill 622, the North Carolina Estimated Tax Underpayment Penalties are now interest and not tax penalties. These new rules apply to individual and corporate taxpayers.

Thus, these underpayment interest charges do not qualify for the penalty abatement program, since the North Carolina Department of Revenue cannot forgive interest.

However, the new interest charges can now be deducted by corporate taxpayers (but not by individual taxpayers - since personal interest expense is never deductible).

XVII. <u>Filing Tax Return Extension Request Will Not Always Prevent Late Filing and Late Tax Payment Penalties</u>.

If an income tax return cannot be filed by the due date, an individual may apply for an automatic six-month extension of time to file the return. To receive the extension an individual must file Form D-410, Application for Extension for Filing Individual Income Tax Return, by the original due date of the return. A copy of the individual's federal extension is not acceptable. Partnerships, estates, or trusts must file form D-410P, Application for Extension for filing Partnership, Estate, or Trust Tax Return, to apply for an extension of time to file a return.

Although a taxpayer is not required to send a payment of the tax estimated to be due, it will benefit the taxpayer to pay as much as possible with the extension request. An extension of time for filing the return does not extend the time for paying the tax. If the tax due is not paid by the original due date, interest will be due on the unpaid amount. The 10 percent late payment penalty will not be due if the taxpayer pays at least 90 percent of the tax liability through withholding estimated tax payments, or with Form D-410 by the original due date.

A late filing penalty may be assessed if the return is filed after the due date (including extensions). The penalty is 5 percent per month ($5 minimum; 25 percent maximum) on the remaining tax due.

If the application for extension is not filed by the original due date of the return, the taxpayer is subject to both a late filing penalty and a late payment penalty. The penalties will also apply if the extension is not valid.

An application for extension is considered invalid if the amount entered on the extension form as the tax expected to be due is not properly estimated. In determining whether the amount reflected as tax due on the application is properly estimated, all facts and circumstances, including the amount of tax due in prior years, whether substantial underpayments have been made in other years, and whether an individual made a bona fide and reasonable attempt to locate, gather, and consult information, must be considered.

XVIII. Separate North Carolina Extension Forms Must Be Filed for Individual Tax Returns and Gift Tax Returns.

The North Carolina Department of Revenue **does not accept** the federal extension forms in lieu of the North Carolina extension forms. Thus, if you wish to extend the time deadline for filing a North Carolina income or gift tax return, you must file a separate North Carolina extension request form rather than simply submitting a copy of the federal extension form to the Department of Revenue. Moreover, the North Carolina Department of Revenue now requires that separate extension forms be filed for gift and income tax purposes.

- Use Form D-410, Application for Extension of Time for Filing Individual Income Tax Returns, to extend the time for filing an individual tax return.

- Use Form D-410P, Application for Extension of Time for Filing Partnership, Estate or Trust Return, for extending the due date of partnership, estate or trust tax returns.

- Use Form D-410G, Application for Extension of Time for Filing Gift Tax Return, in order to extend the time for filing a North Carolina gift tax return.

XIX. New Statute of Limitation on Refund Claims.

Senate Law 1112 has now amended N.C.G.S. 105-266(c)(1) to provide that an agreement by a taxpayer to extend the statute of limitations for assessment of tax will also serve to extend the three year refund claim period as well.

Frequently, in North Carolina Department of Revenue Audits, the Department of Revenue requires the taxpayer to execute a “waiver” agreeing to extend to the statute of limitations period for the Department of Revenue to assess additional tax. Oftentimes, the taxpayer found themselves in a “catch-22" situation if the audit revealed that the taxpayer was entitled to some refund where the statute of limitations for that refund had already expired. Obviously, before the new amendment to GS Section 105-266(c)(1), even if the taxpayer had agreed to extend the statute of limitations in favor of the North Carolina Department of Revenue, the taxpayer could not seek a refund.

Thus, GS Section 105-266(c)(1) was amended to provide that an agreement by the taxpayer to extend the time in which the Department of Revenue can assess the taxpayer with additional tax automatically extends the period of time for refunds of overpayment by the taxpayer.

XX. General Discussion of New Unified Audit Procedures.

Traditionally, a North Carolina tax audit has involved only one schedule of taxes (sales and use, property, corporate and franchise, excise, employment).

As some of you may have experienced, there is a **new unified audit procedure** in which the Department of Revenue may now come in and audit all schedule of taxes in one audit. Thus, under the new "Unified Audit Procedures," North Carolina may come in with one auditor who will audit all schedules.

Therefore, when clients are contacted by the North Carolina Department of Revenue about an upcoming NCDOR audit, they should be wary as to whether only one schedule, versus numerous schedules, are being audited.

Based upon informal discussions with the North Carolina Department of Revenue, we understand that the Department of Revenue will inform the client as to whether they plan to perform a full-blown audit, or audit only one schedule. However, if an auditor calls a client for an audit and does not specifically discuss which specific schedule (sales, use, income, gift) will be audited, you should be wary and concerned that the audit may be a unified audit covering all areas.

What happens after the unified audit is complete? If, during a unified audit, the Department of Revenue requests to look at a specific schedule, if no adjustments are made to that schedule, you may assume that the schedule is satisfactory and has passed audit, and that it will not be looked at again at audit. However, if the Department of Revenue does not specifically look at a schedule, then there is no guarantee that the NCDOR will not come back and look at that schedule again.

XXI. Powers of Attorney and Notification Procedures.

Whenever submitting a Power of Attorney to the North Carolina Department of Revenue, the Federal Form 2848 cannot be used, unless the Federal Power of Attorney (Form 2848) specifically states that it is applicable to some specific North Carolina Tax. Instead, tax practitioners should submit the North Carolina Power of Attorney, Form 58. Many tax practitioners have been under the misimpression that they could simply submit a copy of the Federal Form 2848, Power of Attorney, to the North Carolina Department of Revenue. However, the North Carolina Department of Revenue advises that a separate specific North Carolina Form must be used.

North Carolina tax practitioners should also be cognizant of the fact that the North Carolina Department of Revenue is **not required** to provide taxpayer representatives with carbon copies of correspondence sent to taxpayers or with prior notice before taking action against the taxpayer. Perhaps, tax practitioners should send a separate letter to the North Carolina

Department of Revenue Agent requesting to be sent a carbon copy of any correspondence sent to the taxpayer, or to be given prior advance notice of any adverse action taken directly against the taxpayer.

Conclusion

If you want to know more about any of these topics, the North Carolina Department of Revenue website is www.dor.state.nc.us.