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NORTH CAROLINA STATE AND LOCAL TAX UPDATE

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Introduction

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 state and local tax issues, as well as certain Department of Revenue procedural changes of interest to North Carolina state tax practitioners.

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.

Please note that this manuscript went to print on **October 6, 2009**, 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. New Individual Income Tax Rate Surcharge

A. Background. The personal income tax rate, applied to higher income individuals, was reduced from 8.25% to 8% for the 2007 taxable year, and to 7.75% beginning with the 2008 taxable year. Senate Bill 1741 (effective July 1, 2006).

B. New Personal Income Tax Surtax For 2009 and 2010. Under new N.C.G.S. 105-134.2A, individuals who meet certain income thresholds will pay a "surtax" on the amount of personal income tax they owe, before considering any reductions for withholding, payments or credits, as shown on Line 14 of the D-400 Individual Tax Return.

Here is the Surtax Percentage Table for the surtax thresholds:

Filing Status	NC Taxable Income shown on Line 13	Surtax Percentage
Married Filing Jointly/ Surviving Spouse	More than $100,000 up to $250,000	2%
Married Filing Jointly/ Surviving Spouse	More than $250,000	3%
Head of Household	More than $80,000 up to $200,000	2%
Head of Household	More than $200,000	3%
Single	More than $60,000 up to $150,000	2%
Single	More than $150,000	3%
Married Filing Separately	More than $50,000 up to $125,000	2%
Married Filing Separately	More than $125,000	3%

Here is how the new surtax works: Assume the filing status is “married filing jointly” and that the North Carolina taxable income shown on Line 13 of Form D-400 is $150,000. You would compute the “regular” state income tax on Line 14 and then multiply that amount by 2 percent. You would then add this surtax amount to the “regular” tax on Line 14 to calculate the total tax liability. Then, subtract credits, withholding, payments, etc., to find out if the taxpayers are due a refund or if any additional tax is owed.

Note: The new surtax will be effective for 2009 and 2010 and expires for tax years beginning on or after January 1, 2011.

Note: There is no penalty (interest) for underpayment of estimated tax if the underpayment is attributable to the new surtax.

II. New Personal Income Tax Add-Backs

The new 2009 Legislation updates North Carolina's personal income tax conformity date from May 1, 2008 to May 1, 2009, subject to certain specified exceptions, effective beginning with the 2008 tax year. However, any amendments to the IRC enacted after May 1, 2008, that increase North Carolina taxable income, will become effective for the 2009 tax year.

Specifically, North Carolina "decouples" from the following federal income tax provisions enacted under the federal Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009, and thus the following are new “add backs" beginning with the 2009 tax year:

1. additional federal standard deduction for state and local real property taxes; and
2. federal deduction for motor vehicle sales and use tax.

III. Individual Income Tax Add Back for Federal Accelerated Bonus Depreciation.

A. Introduction. The new Economic Stimulus Act of 2008 allows for 50% first year bonus depreciation deductions for federal income tax purposes under Section 168(k) of the Internal Revenue Code.

B. New Add Back. Effective for tax years beginning on or after January 1, 2008, House Bill 2436 has added a new subsection N.C.G.S. 105-134.6(c)(8a) to require a taxpayer to add back, to federal taxable income (for North Carolina tax purposes), a certain percentage of the 50% first year bonus depreciation deduction allowed for federal income tax purposes under Section 168(k) of the Internal Revenue Code under the Federal Economic Stimulus Act of 2008.

The applicable add back percentage for North Carolina tax purposes is 85% of the bonus depreciation deduction for the 2008 tax year.

Note: This North Carolina add back does not affect the basis of affected assets for state or federal income tax purposes. In other words, the federal and North Carolina tax basis will be the same for income tax purposes even if the affected asset is sold.

IV. Individual Future Deductions for Special Accelerated Depreciation Add Back.

Effective for taxable years beginning on or after January 1, 2008, House Bill 2436 added N.C.G.S. 105-134.6(b)(17a) to provide a deduction from future income tax returns for 50% additional first year depreciation deduction required to be added back to federal taxable income under N.C.G.S. 105-134.6(c)(8a). The taxpayer may deduct 20% of the total amount of the accelerated depreciation added to federal taxable income in the 2008 tax year in each of the first five taxable years beginning on or **after January 1, 2009**.

Thus, a North Carolina taxpayer is required to add back (for North Carolina tax purposes) 85% of the federal first year depreciation deduction in 2008 and may then deduct this add-back amount over the next five (5) years beginning in 2009.

Note: Even if the taxpayer subsequently sells the affected asset in 2009 or thereafter, the taxpayer still is allowed to deduct 20% of the total 2008 tax add back over the next five (5) years.

V. North Carolina Tax Treatment of 2008 Federal NOL Carrybacks For Personal Income Tax Purposes

A. Background. Under the American Recovery and Investment Act of 2009 (ARRA), signed into law by President Obama on **February 17, 2009**, for federal income tax purposes, individuals are now allowed extended three, four, or five-year carryback periods for **2008 NOLs** incurred by an "eligible small business." Generally, under ARRA, an "eligible small business" is a business that meets a $15 million average annual gross receipts test.

Of course, at that time, there was no provision under North Carolina law to permit such three, four or five year carrybacks. Under then current North Carolina law, an individual's NOL could only be carried back two (2) tax years preceding the loss year, and then carried forward to each of the next twenty (20) tax years following the loss year.

B. May 18, 2009; North Carolina DOR Issues Favorable Announcement on Treatment of Extended NOL Carrybacks. In May 2009, the North Carolina Department of Revenue issued a Personal Income Tax Notice on the personal income tax treatment of the five-year carrybacks of 2008 net operating losses (NOLs) for "eligible small businesses."

The notice advised that, at that time, there was no provision in North Carolina law to allow individuals the extended three, four, or five-year carryback period for 2008 NOLs allowed to certain eligible small businesses for federal tax purposes under the American Recovery and Reinvestment Act of 2009 (ARRA), signed into law by President Obama on February 17, 2009. Generally, under ARRA, an "eligible small business" is a business that meets a $15 million average annual gross receipts test.

Instead, under then-current North Carolina law, an individual's 2008 NOL could generally be carried back two taxable years preceding the loss year (2006 and 2007) and carried forward to each of the succeeding 20 taxable years following the loss year, or only carried forward if the taxpayer waives the entire carryback period. At that time, in May, the state's current reference to the Internal Revenue Code was May 1, 2008 and, therefore, did not include the Internal Revenue Code provisions enacted on February 17, 2009. Adopting such provisions would require enabling legislation by the North Carolina General Assembly.

Because of the difference in federal and state law for the tax year to which the 2008 NOL may be carried back for federal and state purposes, the North Carolina Department of Revenue announced that individual taxpayers would have **three (3) options** for dealing with 2008 NOLs for "eligible small businesses":

- carry back the 2008 NOL for North Carolina purposes to the **same tax year**, electing the federal three, four, or five-year carryback under the ARRA by amending the same applicable prior year state returns as those for federal purposes (assume North Carolina would adopt federal law);
- carry back the entire NOL for North Carolina purposes to tax years 2006 and 2007, while electing the 3, 4 or 5 year extended carryback period for federal purposes (assume NC would not adopt federal law); or
- carry back the NOL for federal **and** North Carolina purposes to tax year 2006 and 2007, rather than electing the federal three, four, or five-year carryback under the ARRA.

The May 2009 Notice contained additional detailed instructions for filing under each option, along with additional actions required depending upon whether or not the General Assembly ultimately adopted the federal extended carryback provision.

Regardless of which option was chosen, taxpayers were instructed to include a statement on the Amended North Carolina Individual Income Tax Return, Form D-400X, identifying to which tax years the NOL was carried for federal and state purposes.

Important Notice on State Tax Treatment of Five-Year Carryback of 2008 Net Operating Loss (NOL) for Eligible Small Businesses, North Carolina Department of Revenue, May 18, 2009

C. North Carolina Law Now Conforms to Federal 2008 NOL Carryback Rules

The new 2009 Summer Legislation updated the Internal Revenue conformity date from May 1, 2008 to May 1, 2009. Therefore, the North Carolina Department of Revenue (DOR) announced that, as a result of North Carolina's update to its Internal Revenue Code (IRC) conformity date, North Carolina law now conforms to the federal extended carryback of 2008 net operating losses (NOLs) for personal income tax purposes for NOLs incurred in 2008 by "eligible small businesses."

Thus, under current North Carolina law, an individual is **required** to carry back the 2008 NOL to the **same tax year(s)** for federal and state individual income tax purposes.

The DOR will now process amended state returns previously filed in which the three, four, or five-year carryback election was made for both federal and state purposes. The DOR had previously announced that it would hold such returns pending legislative action by the North Carolina General Assembly.

Taxpayers that carry the 2008 NOL back for three, four, or five years for federal tax purposes, but only carried back the NOL for two years for state tax purposes, now must file

additional **amended** **state** **returns** to carry the NOL back to the same tax year as that elected for federal purposes. Taxpayers will also **be required** to revise the previously filed 2006 and 2007 amended state tax returns. A copy of the federal Form 1045, with Schedules A and B used for federal purposes, should be attached to the amended state tax returns.

Announcement, North Carolina Department of Revenue, August 14, 2009

VI. Qualified Business Investment Tax Credit: Excess Qualified Business Investment Tax Credits Could be Carried Over

On May 5, 2009, the North Carolina Court of Appeals ruled in favor of the taxpayer and against the Secretary of Revenue, and held that any qualified business investment credits, that exceeded the $50,000 annual statutory limitation, could be carried over for five (5) succeeding tax years, rather than being disallowed as the Department of Revenue contended. The Department had argued that the statute precluded a taxpayer from receiving more than $50,000 in total credits for investments **made in a single taxable year.** However, the Court of Appeals determined that the plain language of the statute permitted a taxpayer to carryover unused amounts of credit accrued in one year that were in excess of the $50,000 annual limit to subsequent years.

Department of Revenue v. Hudson, North Carolina Court of Appeals, No. COA 08-945, May 5, 2009, CCH ¶202-443

VII. 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).

VIII. **The New Parental Savings Trust Fund; CH 323 (H.B. 1473) (2007)**.

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. 2006 Tax Rules. 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, **unless** 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. 2007 Tax Changes. 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.

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. 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 Seven 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.

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. Failure to File Amended North Carolina Return Results in Forfeiture of Net Operating Loss Carryback and Net Operating Carryforwards.

In Secretary of Revenue Decision 2006-314 (July 20, 2007), the taxpayers were North Carolina shareholders of an S Corporation. The S Corporation incurred a loss of over $300,000 during the 2001 tax year and the S Corporation "pass through" loss resulted in the taxpayers incurring a net operating loss ("NOL") of over $90,000 on their 2001 federal and North Carolina tax returns.

The taxpayers then amended their 1999 federal income tax return to claim a carryback of the 2001 NOL into the 1999 tax year. For federal tax purposes, the entire NOL carryback to 1999 was absorbed in that 1999 tax year.

Unfortunately, the taxpayers **did not** amend their 1999 North Carolina income tax return to carry back the 2001 net operating loss. Instead, the taxpayers attempted to carry forward the NOL into 2002 and 2003 for North Carolina income tax purposes.

The North Carolina Department of Revenue disallowed the 2002 and 2003 NOL carryforwards since the North Carolina NOL must conform to the taxpayer's treatment of the

NOL for federal tax purposes. In other words, since the taxpayers carried the NOL back to 1999 for federal tax purposes, the taxpayers were **required** to carry the NOL back to 1999 for state income tax purposes as well. Of course, unfortunately for the taxpayers, the statute of limitations for filing an amended North Carolina refund claim for 1999 had already expired at the time the NCDOR audit for 2002 and 2003 took place.

In addition, the taxpayer's likewise were prohibited from carrying their NOL forward into 2002 and 2003. Since the NOL was fully absorbed for federal tax purposes for 1999, there was no remaining NOL to be carried forward for state tax purposes into 2002 and 2003.

NOTE: The lesson here is that, whenever a client has a NOL for federal tax purposes and the client wants to carry that return back for federal tax purposes, the taxpayer must also file an amended North Carolina return for that same year. And, the taxpayer must do so before the statute of limitation's refund claim expires. Otherwise, the client will lose the North Carolina tax benefit for the NOL carryback.

XIII. Bad Debt Deduction Disallowed For Shareholder Who Made Loans to His Corporation; Sec. of Rev. Decision 2007-199.

In Secretary of Revenue Decision 2007-199 (December 5, 2007), the North Carolina Department of Revenue disallowed a bad debt deduction for worthless loans made by a taxpayer to his start-up corporation. The Secretary of Revenue ruled in favor of the NC DOR on the following basis:

1. The loan made by the taxpayer to his start-up corporation was not a loan, but was a contribution to capital; and

2. The debt had not become worthless in the year the loss was claimed.

In this case, that taxpayer contended that, when he made the loan to his closely-held corporation, he intended that the loans would be repaid from the corporation's future profits. However, the Secretary of Revenue found that the taxpayer did not anticipate being repaid - unless the corporation's business profits were sufficient to pay other creditors. According to the Secretary of Revenue, this arrangement did not reflect a true loan arrangement, since a bona fide lender would not make business loan without a firm expectation of repayment. Moreover, although the loan documentation provided for payments of interest, the corporation never actually made any payment of interest or principal on the loan.

The Secretary of Revenue also determined that, even if the capital contributions could be recharacterized as loans, the loans had not become worthless in the year the bad debt deduction was claimed. Although the taxpayer contended that the business had suspended its operations, the corporation had not dissolved or filed bankruptcy, and therefore the corporation was still viable as a going concern. Thus, the debt had not become worthless in the year that the bad debt deduction was claimed.

XIV. <u>No Personal Income Tax Deductions Allowed for "Hobby Losses" Relating to Dog Breeding/Showing Activity</u>.

A. <u>Introduction</u>. Secretary of Revenue Decision 2007-101 (December 6, 2007) involved a taxpayer who claimed losses on her North Carolina tax returns for her dog breeding/showing activities.

In this case, for 2002 and 2003, the taxpayer filed Federal Schedules C for her interior design business and for her dog breeding/showing activity. During these two tax years, the taxpayer's principal source of income was from her interior design business.

Upon audit, the Department of Revenue disallowed the Schedule C losses relating to the dog breeding/showing activities on the basis that the taxpayer was not able to show that the activity was engaged in "for profit" in accordance with Section 183 of the Internal Revenue Code.

B. <u>General Section 183 "Hobby Loss" Rules</u>.

1. <u>Background</u>. Section 183 denies any deductibility of losses or expenses incurred in connection with a hobby rather than a trade or business. Section 183(a) provides that, if an individual or an S Corporation is engaged in an activity that is not engaged in for profit, no deduction attributable to the activity shall be allowed. Section 183(c) defines an activity "not engaged in for profit" as any activity other than one with respect to which deductions are allowable for the tax year under Section 162 or Section 212. Deductions are allowable under Section 162 or Section 212 **<u>only</u>** where the taxpayer is engaged in an activity with **an actual and honest objective of making a profit**.

2. <u>"Three-out-of Five Year" Rule</u>. Section 183(d) provides that an activity will be <u>presumed</u> to be an activity "engaged in for profit" if income exceeds deductions in **three out of five** consecutive taxable years.

3. <u>Facts and Circumstances Test</u>. Finally, Treas. Reg. 1.183-2(b) lists some of the factors to be considered in determining whether an activity is engaged in for profit. The factors listed include:

1. the manner in which the Taxpayer carries on the activity;

2. the expertise of the Taxpayer or his advisors;

3. the time and effort expended by the Taxpayer in carrying on the activity;

4. the expectation that the assets used in the activity may appreciate in value;

5. the success of the Taxpayer in carrying on other similar or dissimilar activities;

6. the Taxpayer’s history of income or losses with respect to the activity;

7. the amount of vocational profits, if any, which are earned;

8. the financial status of the Taxpayer; and

9. the involvement of elements of personal pleasure or recreation.

C. N.C. Secretary of Revenue Decision 2007-101. Indeed, there were many factors which indicated that the dog breeding/showing activities were not engaged in "for profit." For example, the taxpayer could not provide receipts and invoices which substantiated the amount of income or expense amounts claimed on the federal Schedule C for the dog breeding/showing activities. The taxpayer also used the same checking account to pay for expenses for her interior design services and for her dog breeding/showing activities. Also, the taxpayer's records were not organized and the North Carolina Department of Revenue auditor was not able to distinguish between the personal versus potential business expense.

Moreover, the taxpayer did not maintain records to track income and expenses attributable to any dog. There were no accounting books for this activity that would allow the taxpayer to analyze profit potential of the activity so as to make an informed decision regarding its profitability.

Also, the taxpayer did not develop a business plan for her dog breeding/showing activity. The taxpayer could not prove how much time and effort was put into the dog breeding/showing activity.

Although the taxpayer was a member of various dog kennel clubs and attended classes on grooming and handling dogs, she had not been successful in a similar activity in the past and she could not prove that she was undertaking any ongoing analysis efforts to determine how she ultimately would be able to turn her dog breeding/showing activity into a bona fide "for profit activity."

Although the taxpayer stated that she intended to make a profit on her activities, she was not able to furnish any meaningful projections showing how she could ever reasonably expect to make any such profits. Also, the taxpayer could not prove that losses reported were due to circumstances beyond her control.

Ultimately, in this case, the taxpayer could not prove to the North Carolina Department of Revenue that she was engaged in the dog breeding/showing activity for profit.

Note: Also note that a ten percent (10%) North Carolina negligence penalty was also assessed.

XV. 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 outside 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 <u>abandoned</u>.

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.

PART TWO
PROPERTY TAX DEVELOPMENTS

I. Property Tax: Nonprofit Organization Denied Property Tax Exemption

In Eagles' Nest Foundation (NC Court of Appeals, January 6, 2009), a nonprofit organization owned real property which it used for **both** a summer camp and a winter school. The North Carolina Court of Appeals ruled the property did not qualify for North Carolina property tax exemptions because the property was not wholly and exclusively used for educational purposes (N.C.G.S. 105-278.4(a)), nor was the organization a charitable association or institution (N.C.G.S. 105-278.6).

The taxpayer contended that it was entitled to a property tax exemption because it exclusively dedicated its property to educational endeavors (the winter school). However, the Court of Appeals rejected that argument because, during the summer months, when the summer camp was operated, the property was used primarily for "recreational" purposes.

The taxpayer's second argument, that it was a charitable association or institution, was also rejected because a "charitable purpose" is one without expectation of pecuniary profit, and the taxpayer's organization charged tuition of approximately $15,000 per semester per student for the winter school, and charged the market rate for patrons of the camp. Further, the organization only provided approximately 2% of the camp's revenues to campers in the form of financial aid.

In the Matter of Appeal of Eagle's Nest Foundation, North Carolina Court of Appeals, No. COA 08-316, January 6, 2009.

II. New Property Tax Deferral for Builders Who Hold Real Property For Sale to Customers.

North Carolina has enacted legislation that permits deferral of a portion of the property tax due on real property held for sale by a “builder”. A “Builder” is defined as a taxpayer that is licensed as a general contractor and that is engaged in the business of buying real property, making improvements to it, and reselling it.

Effective for taxes imposed for taxable years beginning on or after July 1, 2010, a builder may defer the portion of tax imposed on real property that represents the increase in value of the property attributable solely to residential improvements constructed by the builder. A “residence” is defined as an improvement, other than remodeling, renovating, rehabilitating, or refinishing, by a builder to real property that is intended to be sold and used as an individual’s residence, that is unoccupied, and for which a certificate of occupancy authorized by law has been issued.

The difference between the taxes due and the taxes deferred are a lien on the property of the taxpayer. The deferred taxes are due when the property loses its eligibility for deferral because of the occurrence of a “disqualifying event”. A “disqualifying event occurs at the earliest of:

- when the builder transfers the residence;

- when the residence is occupied by the builder or someone other than the builder with the builders consent;

- five years from the time the improved property was first subject to being listed for taxation by the builder; or

- three years from the time the improved property first received the property tax benefit.

The Act is repealed effective for taxes imposed for taxable years beginning on or <u>after July 1, 2013</u>; however, a residence receiving the property tax benefit provided by the Act is not affected by the repeal until the occurrence of a disqualifying event.

Ch. 308 (H.B. 852), Laws 2009

III. <u>Property Taxes: New Information Requirements Imposed on Conveyance Deeds</u>

North Carolina has enacted new legislation requiring certain information to be included on property conveyance deeds in order to assist counties and the Department of Revenue in obtaining accurate real property sales information needed for property tax appraisals. Effective January 1, 2010, each deed conveying property must contain (1) the names and mailing addresses of each grantor and grantee, <u>and</u> (2) a statement whether the property includes the primary residence of the grantor. New N.C.G.S. 105-317.2. Further, it is the duty of the person presenting an instrument for registration to report to the Register of Deeds the correct amount of deed stamp tax due. Amended N.C.G.S. 105-228.32. These changes are effective as of January 1, 2010.

S.B. 405, Laws 2009, effective as noted.

IV. <u>Who Is Liable for Delinquent Property Taxes on Real Property Sold During the Tax Year?</u>

A. <u>Background</u>. 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 **<u>next</u>** tax year.

B. <u>Old Law: Seller is Liable for Delinquent Taxes Not Paid by Buyer</u>. 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 <u>real</u> <u>estate</u> <u>sold</u> 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 <u>personal property</u>, 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. <u>New 2006 Law Changes: Now, the Buyer Is Directly Liable for Unpaid Real Property Taxes For the Whole Year</u>! Under new S.B. 1451 (effective July 1, 2006), for the purpose of delinquent **<u>real property</u>** tax collection, North Carolina legislation defines "taxpayer" as the owner of record <u>on the date the real property taxes becomes delinquent</u>. 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.

> **<u>Note: No Change to Rules Applicable to Delinquent Personal Property Taxes</u>**. The new rules do not alter the definition of "taxpayer" for **<u>personal property</u>** 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.

V. House Bill 2346 Modifies N.C.G.S. 105-277.1(c) and Now Provides for a Property Tax Exclusion for Honorably Discharged Disabled Veterans and Their Surviving Spouses.

This new provision provides for a property tax exclusion of the first $45,000 of appraised value of the residence owned and occupied by an honorably discharged disabled veteran or the unmarried surviving spouse of an honorably discharged disabled veteran. This new rule is effective for taxes imposed for taxable years beginning on or after July 1, 2009.

VI. New "Present-Use Value" Property Tax Change For Farm Land Allows For Additional Forms of Ownership to Qualify.

Senate Bill 1878 has amended N.C.G.S. 105-277.2 to change the "present-use" value law to allow additional forms of farm land ownership to qualify for special property tax value treatment. This new rule modifies the present-use value ownership requirements to reflect modern estate planning and allows property to remain in the "present-use value" when the new owner continues to farm the land and files for an application for a present-use status.

This new provision changes the types of business entities and trusts which can qualify for present use value for farm land. All members of the business entity must be directly or indirectly individuals who are actively engaged in farming agricultural land, horticultural land or forestland. This new law allows land to immediately qualify without requiring the deferred taxes to be paid at the time of transfer as long as the new owner continues to use the land for the purpose for which it was classified under the previous ownership.

(Effective for taxes imposed for taxable years beginning on or after July 1, 2008; SB 1878).

NOTE: As a "best practice," the new trust or business entity should file a new application for "present use" farm value status.

VII. <u>2006 House Bill 1465 Now Extends "Farm Land" Property Tax Qualification to Owners Who Lease Farm Land</u>.

A. <u>Introduction</u>. 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. <u>New Legislative Amendments</u>. 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, <u>as</u> <u>long</u> <u>as</u> 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.

VIII. <u>County Board of Equalization May Now Consider Late "Present Use" Value Applications</u>.

A. <u>Background</u>. 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 <u>timely</u> 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. <u>Prior Law: "Present Use Value" Application and Due Dates for Pre-2007 Tax Years</u>. A taxpayer must file a <u>timely</u> 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. North Carolina Gift Tax Is Repealed Effective January 1, 2009.

A. Introduction. Prior to 2008, only four states had 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, prior to 2008, the legislature had not repealed the North Carolina gift tax.

B. Gift Tax Rules for 2008. For 2008, North Carolina retained 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.

C. Conformity With North Carolina Gift Tax Law - Increase in Annual Gift Tax Exclusion. As a result of conformity changes with the federal tax system, the North Carolina annual gift tax exclusion for 2008 gifts is $12,000 per donee per year.

D. North Carolina Gift Tax Repealed for 2009. The North Carolina gift tax has been repealed for gifts made on or after January 1, 2009. **(HB 2436, 2008).**

E. North Carolina Department of Revenue Appears To Be Auditing Gift Tax Returns for Pre-2009 Years.

II. 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, and could be subject to late filing and late payment penalties.

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

III. Gift Tax: Temporary Transfer to Avoid Creditors Was Subject to Gift 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).

IV. 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?

V. 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. North Carolina Department of Revenue and Court of Appeals Take 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), and NCDOR v. Von Nicolai, 681 S.E.2d 431 (August 18, 2009). 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.

See also NCDOR v. Von Nicolai, 681 S.E.2d 431 (August 18, 2009)

VI. North Carolina Estate 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 2006 with an estate of less than $2.0 Million will not owe any North Carolina estate tax. Likewise, the estate of a decedent dying after January 1, 2009 with an estate less than $3.5 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 2008 or 2009 with estates over $2.0 Million and $3.5 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.

VII. 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.

VIII. North Carolina Modifies The Formula For Calculating the North Carolina Estate Tax When a North Carolina Resident Dies and Owns Property in More Than One State.

House Bill 3426 (2008) modifies the formula for calculating the North Carolina estate tax where a North Carolina resident dies owning property in more than one state. The North Carolina Department of Revenue issued a Notice dated August 5, 2008 explaining how this change will work. The following are excerpts from the August 5, 2008 Notice.

A. Introduction and Background. Where a decedent dies owning property **only in North Carolina**, the North Carolina estate tax that is due is the amount of the federal state death tax credit that would have been allowed for federal estate tax purposes as of December 30, 2001.

These rules become more complicated where a decedent dies owning property in **more than one state**. In those cases (where the decedent dies owning property in more than one state), the federal estate death tax credit amount must be prorated between North Carolina and the other state where the decedent held property.

B. <u>Prior Law</u>. Before the enactment of House Bill 3426, the amount of the 2001 federal estate death tax credit payable to North Carolina was **<u>reduced</u> <u>only</u>** by the **<u>lesser</u> <u>of</u>**:

(i) the amount of the estate tax paid to the other state, or

(ii) the amount of the 2001 federal estate death tax credit multiplied by a fraction, the numerator of which was the value of the property located out-of-state, and the denominator of which was the value of the gross estate.

Many practitioners have believed that this formula produced an unfair result to a North Carolina estate (with property in more than one state) when the other state either

(i) did not impose an estate tax, or

(ii) where the other state imposed an estate tax that is less than the pro rated federal credit amount.

In those cases, the North Carolina formula would provide less than a full reduction of the North Carolina estate tax attributable to the out-of-state property.

C. <u>New House Bill 3426</u>. Under the new House Bill, the "lesser of" language is removed and now the amount of the North Carolina estate tax imposed is **reduced solely** by the amount of the 2001 federal estate death tax credit multiplied by a fraction, the numerator of which was the value of the property located out-of-state, and the denominator of which was the value of the gross estate.

D. <u>Effective Date</u>. This new rule becomes effective July 16, 2008, and applies **<u>retroactively</u>** to the estates of decedents for which the statute of limitations for claiming a refund has not expired as of December 28, 2007. If the Estate is effected retroactively by the new legislative changes, the Estate may file an amended North Carolina estate tax return using Form NC-19, Claim for Refund of Taxes. "Estate Tax Law Change" should be written on the front of the return in the upper right-hand corner. The amended return should be sent to the North Carolina Department of Revenue, Attention: Estate Tax Refund, Work Station Number 4546, PO Box 871, Raleigh, NC 27602-0871.

NOTE: The above is taken from Notice, North Carolina Department of Revenue, August 5, 2008.

PART FOUR
NORTH CAROLINA SALES AND USE TAX DEVELOPMENTS

I. <u>Increased General Sales Tax Rate</u>

The General Assembly enacted new legislation to **"<u>temporarily</u>"** increase the North Carolina state rate of sales and use tax by 1%. The increase is effective September 1, 2009, and it expires July 1, 2011.

Effective September 1, 2009, the **general state rate** of sales and use tax is **<u>increased</u>** from 4.5% to 5.5%. Effective October 1, 2009, the rate increases to 5.75% (the rate already was scheduled to increase to 4.75% effective October 1).

The local county tax rate **<u>decreases</u>** from 2.5% to 2.25% in all counties except Alexander, Catawba, Cumberland, Haywood, Martin, Pitt, Simpson and Surry, where the county rate continues at 2.5%. Mecklenburg County has an additional 0.5% county rate.

So, **effective October 1, 2009**, the combined rate is 7.75% in 91 counties, 8% in Alexander, Catawba, Cumberland, Haywood, Martin, Pitt, Sampson, and Surry Counties, and 8.25% in Mecklenburg County.

Note: The "temporary" state sales tax rate increase is scheduled to <u>expire</u> **on July 1, 2011**. N.C.G.S. 105-164.4(a).

II. <u>Sales and Use Tax Now Payable on Certain Online Purchases of Digital Download Items</u>.

Under new N.C.G.S. 105-164.4(a)(6b), sales and use tax will now be payable on certain digital downloads of items, such as songs, books, newspapers, magazines and movies. These changes are **effective January 1, 2010**. The N.C. Department of Revenue says it will provide a more detailed interpretation of this change soon.

III. <u>New "Amazon" Sales Tax Statute for Certain Online Retailers – Online Sales Made by Referrals from N.C. Website Owners</u>

N.C.G.S. 105-164.8(b)(3) has been amended to create a "rebuttable presumption" that certain online retailers will be deemed to be soliciting business in North Carolina, for sales tax purposes, if an in-state entity refers customers to the retailer by a website link, in return for a commission to the in-state referral entity - also known as a web site "click-through." This new legislation is similar to the "Amazon law" enacted by the State of New York.

Under this new amended N.C.G.S. 105-164.8(b)(3), online retailers **who have more than $10,000 worth of sales** (during the last four (4) quarterly periods) through online referrals from websites owned by North Carolina residents – such sales are also known as “click-thru’s,” –

would be **"presumed"** to be soliciting sales in North Carolina and would have to charge sales tax on all sales to North Carolina residents. The online retailer could "rebut" the presumption by proving that the in-state entity did not engage in any solicitation in North Carolina on the retailer's behalf that would satisfy the "nexus" standards under the U.S. Constitution.

IV. Seller Not Liable for Overcollected Sales Tax Based on Written Advice From North Carolina Department of Revenue

A seller, who requests specific written advice from the Secretary of Revenue and who collects and remits North Carolina sales or use tax in accordance with that written advice, is not liable to a purchaser for any overcollected sales or use tax that was collected pursuant to the advice.

CH 413 (S.B. 909), Laws 2009, effective August 5, 2009. Amended N.C.G.S. 105-164.11.

V. New Sales Tax Refund for Certain Section 501(c)(3) Organizations.

A. Introduction. N.C.G.S. 105-164.14(b) was rewritten under HB 2436 (2008) to now clarify the types of entities that can qualify for semi-annual refunds of sales and use taxes paid on direct purchases of tangible personal property.

B. Prior Law. Previously, N.C.G.S. § 105-164.14(d) provided that certain non-profit educational, charitable and religious organizations could apply and obtain refunds of sales taxes. The problem was that this test was somewhat subjective and not objective and therefore there was an occasional dispute between the Department of Revenue and taxpayers as to whether an organization, already granted § 501(c)(3) status by the Internal Revenue Service, would be eligible for refunds as an educational, charitable or religious organization.

C. New Law. As rewritten, the Section 105-164.14(b) refund provisions now apply to an organization that is exempt from income tax under Section 501(c)(3) of the Internal Revenue Code and which is **not** classified in any of the following major group areas of the National Taxonomy of Exempt Entities: community improvement and capacity building, public and social benefit, or mutual membership benefit.

This new change is effective July 1, 2008, for purchases made **on or after July 1, 2008**. House Bill 2436.

VI. Responsible Person Liability for Trust Fund Taxes

A. Background. Individual officers and directors of a corporation are usually not liable for corporate debts or obligations. General partners of a partnership, on the other hand, are always personally liable for debts and liabilities of the partnership.

B. "Responsible Person" Liability Under N.C.G.S. 105-242.2. However, by statute, a "responsible officer" of a corporation or a limited liability company may be held personally liable for certain unpaid "trust taxes" owed by the business entity, such as sales and use, motor fuels, and income withholding taxes. A "responsible officer" is defined as any of the following:

(i) the president, treasurer, and the CFO of a corporation,

(ii) the manager of an LLC, and

(iii) any other officer of a corporation or a member of a LLC who has a duty to pay trust taxes on behalf of the entity.

Note: This statute was amended in 2007 to **add CFOs** to the list of persons who are automatically deemed "responsible persons."

C. Now, Partners Are Added to the List of "Responsible Persons." Prior to 2008, there was no similar statutory provision to assess partners for these taxes. Instead, the Department of Revenue, like any other creditor of a partnership, had to sue the partners in order to collect this liability against the partners of a partnership. Once a judgment was obtained, the Department of Revenue had to seek to execute the judgment.

New Senate Bill 1704 (2008) amended N.C.G.S. 105-242.2 to **add general partners** of a partnership to the list of "responsible persons."

Note: SB 1704 also recodified N.C.G.S. 105-253 as new N.C.G.S. 105-242.2.

Effective Date: This change becomes effective July 1, 2008, and applies to taxes that become collectible on or after that date.

VII. 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. 105-242.2, 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.

> **Note**: Likewise, in Secretary of Revenue's Decision 2007-42 (December 18, 2007), a president of a corporation was personally liable for the unpaid North Carolina sales taxes that were collected, but never remitted. According to the Secretary of Revenue, each responsible officer of the Corporation is personally and individually liable for all of the sales taxes collected by the corporation, and the term "responsible officer" is defined to include the corporation's president.

VIII. 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.

Under new 2007 changes, CFOs and Managers are also always responsible persons.

IX. 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.

X. 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 <u>failed</u> 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.

XI. **<u>Taxable Portion of Trade Booth and Display Sales Price Includes Custom Portion of Design Costs</u>**.

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.

XII. 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)

XIII. 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).

XIV. S&U Tax: Sitting Fees are Taxable Charges for "Fabrication Labor"

The North Carolina Court of Appeals has ruled that "sitting fees" are charges for "fabrication labor" of printed photographs, and therefore are subject to North Carolina sales and use taxes.

In Carolina Photography, Inc., the taxpayer was engaged in the business of photographing underclass and senior students at various North Carolina high schools. During photo sessions, the taxpayer arranged a variety of poses, backgrounds, and lighting for **senior** students, for which these seniors were charged a "sitting fee" - regardless of whether the seniors ultimately purchased printed photographs.

The Secretary of Revenue conducted an audit that resulted in additional tax being assessed **only** on those sitting fees that were ultimately followed by a senior's order for printed photographs. The trial court ruled in favor of the taxpayer, and granted a refund of the sales tax assessed on sitting fees collected from seniors who also purchased photographs.

The Court of Appeals, in reversing the order of the trial court granting a refund, first noted that, in its interpretations before and after the audit period, the Department of Revenue has interpreted the meaning of "sales price" to include charges for "fabrication labor" preceding a sale of tangible personal property. Revenue derived from the sales price of tangible personal property is subject to sales and use taxes.

The Court of Appeals therefore held that the taxpayer could not produce or ultimately sell a printed photograph to seniors if it did not first arrange the sitting to take the picture. As a consequence, the sitting fees charged by the taxpayer to each senior student, before the student ordered printed photographs, were part of the sales price of those printed photographs.

Carolina Photography, Inc. v. Hinton, North Carolina Court of Appeals, No. COA 08-609, April 7, 2009

XV. 2007 North Carolina Sales Tax For Interior Designers.

Secretary of Revenue Decision 2006-298 (August 28, 2007) is a disturbing sales tax case, not just for interior designers, but for many service providers who also provide product in addition to providing services.

A. Fact Background. In this case, the taxpayer was an interior design consultant providing commercial and residential interior design services. In addition to providing interior design consultation services, the taxpayer also sold tangible personal property, such as mirrors, book cases, rugs, artwork, wall coverings and other furnishings to some of its customers.

The taxpayer invoiced its customers for selection, preparation and design consultation fees on one or more invoices, and separately invoiced the same customers for sales of tangible personal property, such as mirrors, rugs, lamps, artwork, wall coverings and other tangible personal property.

"Selection" fees were charged when the taxpayer's designers selected various options and data (such as color and styles) for a customer during a design consultation. "Preparation" fees were invoiced when the designer researched and gathered data to be used during the design process.

The design findings, that resulted from the design research, were presented to a customer during a design consultation.

The designer also made substantial sales of home furnishings and other tangible personal property to its retail and commercial clients. Retail sales were made almost exclusively to customers who also received design and space consultation services from the taxpayer.

B. North Carolina Department of Revenue Sales Tax Assessments and The Taxpayer's Position. The North Carolina Department of Revenue assessed the taxpayer for state and local sales taxes it failed to collect on the selection, preparation and other design consultation fees where those services were followed by sales of tangible personal property. The North Carolina Department of Revenue, however, did not assess sales tax on any transactions where a customer hired the taxpayer solely for the purpose of providing design or spacing consultations and where the taxpayer sold no tangible personal property to that customer.

The taxpayer's primary objection to the proposed assessment was based on the taxpayer's assertion that its "primary business" was interior design services, including consultations relating to space planning. The taxpayer contended that she was not a retailer who solicited sales of tangible personal property from its customers. Indeed, the sale of product oftentimes occurred at a date that was far later from the date on which the design services were actually provided.

C. **The Secretary of Revenue's Decision**. Nevertheless, the Secretary of Revenue ruled that, since the design and consultation services ultimately led to the sale of tangible personal property, all of the entire design fees should be subject to sales taxation.

The Department of Revenue noted that, under N.C.G.S. 105-164.3(35), the term "retailer" includes every person engaged in the business of making sales of tangible personal property. Moreover, N.C.G.S. 105-164.3(37) provides that the term "sales price" means the total amount or consideration for which the personal property or services are sold, and that the term "sales price" also includes the retailer's labor or service costs as well as charges by the retailer for any services necessary to complete the sale of tangible personal property. Thus, the Secretary of Revenue concluded that it was the design and consultation services that ultimately led to the sale of product which therefore made the **entire transaction** subject to sales tax, including the separately- stated service charges for design and consultation services.

D. **Did the Secretary of Revenue Fail to Distinguish Between Retail Designers and Commercial Contract Designers?** The interior design industry provides a wide array of services to its various customers.

> **1.** **Residential Designers.** On the one end of the spectrum, there is the residential interior designer who often provides design services with the ultimate goal of being able to sell furniture, furnishings, etc. for a profit mark-up. In that case, it may not seem grossly unfair to charge sales tax on the entire sales/services project, since one may certainly argue that the interior designer engaged in the design services with the ultimate objective of selling product as part of the entire sales/service project.
>
> **2.** **Industrial and Commercial Designers.** On the other hand, for many commercial designers (who service commercial office clients, hotels, senior living facilities and the like), the business model of the interior designer is often much different. In these cases, the commercial designer's primary business objective is to provide services for a service fee. It is usually only much later in the relationship that the client/customer will request that the interior designer arrange for procurement of product. In many cases, the industrial or commercial designer charges only a very small mark-up for the product that is sold, and the subsequent product procurement services often are done only to accommodate the client. In these cases, the lion's share of the gross profit earned by the designer is attributable only to services, and not the sale of the product.
>
> These commercial interior designers often insist that they are merely providing a "procurement service" (at a very small profit mark-up) as an ancillary service to the overall design and consultation services. For these commercial designers, the impact of Secretary of Revenue Decision 2006-298 is patently unfair. Moreover, the commercial interior designer is practically penalized for providing the mere procurement services since these mere procurement services may cause the entire engagement to be subject to North Carolina sales tax.

XVI. <u>New Sales Tax Exemption for Interior Design Services in Connection with Sales of Tangible Personal Property</u>.

Effective August 1, 2008, HB 2436 adds N.C.G.S. 105-164.13(59) to now provide a specific sales tax exemption for interior design services provided in conjunction with the sale of tangible personal property. In order to qualify for the exemption, the charge representing the interior design services **<u>must</u> <u>be</u> <u>separately</u> <u>stated</u>** from the sales price of the tangible personal property.

XVII. <u>Reduction of Certain Sales Tax Assessments Against Small Businesses; New N.C. G.S. 105-244.2</u>

A. <u>Introduction</u>. One of the most significant developments in 2008 was the enactment of new N.C.G.S. 105-244.2. This is a new statute that **<u>requires</u>** the Secretary to reduce an assessment against a small business for state and local sales and use taxes, and to waive penalties, if certain requirements are met.

The following explanation of new N.C.G.S. § 105-244.2 is reproduced from Page 47 of the 2008 Tax Law Change, which can be found on the Department of Revenue's website.

B. <u>Review of New N.C.G.S. 105-244.2</u>. The new G.S. 105-244.2 requires the Secretary to reduce an assessment against a small business, for State and local sales and use taxes and to waive any penalties imposed as past of the assessment, when the assessment is made as the result of an **audit** of the **small business** and **<u>all</u>** of the following apply:

1. The gross receipts of the business for the calendar year preceding the year in which the audit period begins, combined with the gross receipts of all related persons as defined in G.S. 105-163.010, do not exceed one million eight hundred thousand dollars ($1,800,000).

2. The business remitted to the Department all the sales and use taxes it collected during the audit period.

3. The business had not been told by the Department in a prior audit to collect sales and use taxes in the circumstance that is the basis of the assessment, as reflected in the written audit comments of the prior audit.

4. The business made a good faith effort to comply with the sales and use tax laws, and the assessment is based on the incorrect application of one of the following complex areas of these laws:

    a. The rate of tax that applies to prepared food.

    b. The distinction between a retailer and a performance contractor.

    c. The distinction between a service that is necessary to complete the sale of tangible personal property, and is therefore taxable, and a service that is incidental to the sale of tangible personal property, and is therefore not taxable.

    d. The determination of whether a person is a manufacturer.

C. Amount of Assessment Reduction.

The amount by which a sales and use tax assessment against a small business must be reduced under the provisions of the Small Business Protection Act is a percentage of the assessment. The percentage is determined by the average monthly gross receipts of the business for the calendar year preceding the year in which the audit period begins, combined with the average monthly gross receipts of all related persons as defined in G.S. 105-163.010. Any reduction of an assessment and waiver of penalties imposed as part of an assessment apply only to the amount o an assessment attributable to the incorrect application of one of the four complex areas of the law listed above. The following table sets out the applicable percentage reductions of an assessment.

Average Monthly Gross Receipts of Business Over	Average Monthly Gross Receipts Up to	Percentage Reduction
$ 0	$ 50,000	98%
$ 50,000	$100,000	95%
$100,000	$150,000	90%

D. Application of New Rules to Tax Assessments.

The provisions for reducing assessments against small businesses apply to the following:

1. A proposed assessment that is pending on July 15, 2008.
2. An assessment that becomes collectible under G.S. 105-241.22 on or after July 15, 2008.
3. An assessment that meets **all of the following** conditions:

    a. It became collectible under G.S. 105-241.22 before July 15, 2008, or was identified in a notice of final assessment issued under former G.S. 105-241.1 before July 15, 2008.

    b. It is not paid as of July 15, 2008.

    c. If it had been paid within six months after it became collectible under G.S. 105-241.22 or was identified in a notice of final assessment issued under former G.S. 105-241.1, a timely claim for refund could be filed under G.S. 105-241.7 for a refund of the assessment.

4. A claim for refund filed in accordance with G.S. 105-241.7 for a refund of an assessment.

These provisions expire January 1, 2010. The expiration applies to an assessment that becomes collectible under G.S. 105-241.22 on or after the expiration date and to a claim for refund filed on or after the expiration date for a refund of an assessment paid before the expiration date.

E. Possible Examples.

Here is an example how the new rules might apply.

EXAMPLE: First, let's take a carpet installer who installs carpets in residential homes. Two different installers may operate in a very different manner.

For example, you may have one installer who treats himself as a "**performance contractor**." This performance contractor charges a flat fee for the entire contract, for say $10,000. As a performance contractor, the carpet installer does not charge sales tax to his customers, but instead pays use tax on all items purchased to perform the performance contract.

Another carpet installer might treat himself as a **"retailer."** Here, as a retailer, the carpet installer would break his invoice down into a "materials component" and an "installation service component." The materials component would contain the charges for materials (such as carpet, glue, etc.). The retail carpet installer would charge sales tax to the customer only on the materials portion. The carpet installer would not pay North Carolina use tax when he purchases these materials from his vendors. Of course, if installation charges were separately stated, no sales tax would be charged on these installation services.

We have heard of cases where the Department of Revenue's auditor has taken the position that the "performance contractor" was really a "retailer" and vice versa. Recently, I had a client (who actually was a carpenter installer) who treated himself as a retailer (and charged his customer sales tax on sold materials) and the North Carolina Department of Revenue auditor then assessed additional use tax on his material purchases, saying that he was a performance contractor and not a retailer.

For these small taxpayers, this can be a "lose -lose" situation, and therefore the new Small Businesses Protection Act provides some protection for these taxpayers who act in good faith.

PART FIVE
CORPORATE INCOME AND FRANCHISE TAX DEVELOPMENTS.

I. <u>New Corporate Income Tax Surtax for 2009 and 2010</u>

Under new N.C.G.S. 105-130.3B, corporations subject to corporate income tax must pay an income tax surcharge of 3 percent on its North Carolina income tax due - before deducting any tax credits or payments.

S corporations that file "composite" income tax returns on behalf of resident or non-resident shareholders must calculate the amount of North Carolina income tax due separately for each such shareholder. That calculation must include the amount of individual income surtax based on the Surtax Percentage Table for individuals with a filing status of "single."

<u>Note</u>: These changes only apply for 2009 and 2010 tax years, and expire for tax years beginning on or after January 1, 2011.

<u>Note</u>: Again, there is no penalty (interest) for underpayment of estimated tax if the underpayment is because of the surtax.

II. <u>Unitary Reporting Required: Secretary of Revenue Has Authority to Require Combined Reporting</u>

The N.C. Court of Appeals has held that N.C.G.S. 105-130.6, regarding subsidiaries and affiliated corporations, provides the N.C. Secretary of Revenue with the authority to require "combined reporting" if the Secretary of Revenue finds as a fact that a report by a corporation does not disclose the corporation's "true earnings" on its business carried on in North Carolina. *Wal-Mart Stores East, Inc. v. Hinton*, North Carolina Court of Appeals, No. COA08-450, May 19, 2009.

A. <u>Background</u>

In the Wal-Mart case, the taxpayer operated retail stores in North Carolina and in other states. After the taxpayer's parent reorganized its corporate structure, all real property pertaining to Wal-Mart store premises, including both freeholds and leaseholds, was transferred from the taxpayer's parent to a Real Estate Business Trust, which was owned and controlled by the taxpayer.

The NCDOR audited the taxpayer's returns and determined that the taxpayer's earnings had to be combined with Wal-Mart Real Estate Business Trust in order to present its "true earnings" in North Carolina. The Secretary notified the taxpayer to file combined returns and issued a notice of proposed assessment. After the taxpayer's owner remitted an amount to the Secretary in payment of the assessment and an assessment on a related appeal, the taxpayer filed suit demanding a refund of taxes paid. Both parties filed motions for summary judgment and the trial court granted the Secretary's motion.

The appellate court held that the amount the taxpayer sought to classify as "dividends" was in fact rental income. Since more than one-third of the taxpayer's total income on one of its returns was derived from rental of its store properties, the rental income was a principal business activity of the taxpayer. Income is business income unless it is clearly classifiable as nonbusiness income and a taxpayer must establish that its classification of income as nonbusiness income is proper. Dividend income is business income if the dividend is received from a unitary subsidiary of the taxpayer.

B. <u>Authority to Force Combined Reporting</u>

The taxpayer appealed and argued, among other things, that, under N.C.G.S. 105-130.6, the Secretary did not have the authority to force the filing of combined returns, unless the Secretary first determines that the taxpayer has not engaged in "arms-length" transactions with its out-of-state affiliates.

The Court of Appeals, however, held that the language of N.C.G.S. 105-130.6 on its face does not limit the Secretary's authority to require combined reporting, by mandating that he first find that the entity engaged in "non-arm's length dealings" (i.e., conducted intercompany transactions at amounts other than fair value). The statutory language is broad and allows the Secretary to require combined reporting if he finds as a fact that a report by a corporation does not disclose the **"true earnings"** of the corporation on its business carried on in the state. The statute does not restrict the Secretary to a finding of a particular type of transaction or dealing.

What are "True earnings." The taxpayer defined "true earnings' as what the taxpayer's income would be if it had no affiliates and dealt with all parties on an arm's length basis. The appellate court, however, rejected the taxpayer's proposed definition of "true earnings" and held that the essential meaning of the phrase "true earnings" refers to the limit on state taxation as found under the U.S. Constitution. There are two different methods for calculating true earnings: (1) if the intrastate activities of an entity amount to a **"discrete business enterprise,"** the net income of that discrete business enterprise represents the true earnings in the state; (2) if, however, the entire enterprise is a **"unitary business,"** true earnings in the state may be calculated by apportioning the earnings of the entire enterprise on the basis of sales and other indicia of activity within the state. Functional integration is key and whether the earnings are derived as divisional profits from a legally integrated enterprise or as dividends from a legally separate entity is of no consequence in determining if a business is "unitary" for the purpose of computing true earnings.

The appellate court noted that, if a taxpayer reports income based on the "discrete enterprise" method, then absent any non-arm's length transactions, the taxpayer's reported income will reflect its "true earnings" in the state. However, where a taxpayer's business is "unitary," and as in the present case, the taxpayer attempts to reclassify income as nonbusiness or nonapportionable, the reclassification has the potential to distort true earnings in North Carolina - even if all intercompany transactions are accounted for at arm's length or fair value prices.

C. And, Penalty Assessments Also Were Proper

Penalties assessed against the taxpayer for negligent behavior in filing returns were affirmed. Although the taxpayer argued that it was not negligent in the original filings because those filings were made on a separate company basis and combined returns can only be filed when specifically requested by the Secretary, the appellate court held that the statute by which the penalties were assessed does not require a finding of negligence. Since the Secretary's assessment based on the combined returns was lawful, the taxpayer had understated its taxable income by more than 25%.

Wal-Mart Stores East, Inc. v. Hinton, North Carolina Court of Appeals, No. COA08-450, May 19, 2009.

The above-referenced summary was reproduced from CCH State Tax Review (May 29, 2009).

III. <u>New 2008 Corporate Income Tax "Add Back" for First Year Bonus Depreciation for Federal Income Tax Purposes</u>.

A. <u>Introduction</u>. Effective for taxable years beginning on or after January 1, 2008, House Bill 2436 added N.C.G.S. 105-130.5(a)(15)(a) to require corporate tax back to add to federal taxable income a percentage of the 50% first year bonus depreciation deduction allowed for federal income tax purposes under Section 168(k) of the Internal Revenue Code under the Federal Economic Stimulus Act of 2008. The applicable percentage add-back for North Carolina income tax purposes is 85% of the federal bonus depreciation for the tax year 2008.

B. <u>Future Deductions for 50% First Year Accelerated Depreciation Add Back</u>. Effective for taxable years beginning January 1, 2008, House Bill 2436 added N.C.G.S. 105-130.5(b)(21)(a) to provide a deduction for future North Carolina income tax returns for the 50% first year depreciation deduction required to be added back to federal taxable income under N.C.G.S. 105-130.5(a)(15)(a). A taxpayer may deduct 20% of the total amount of the accelerated depreciation added to federal taxable income in the year 2008 in each of the first five taxable years beginning on or after January 1, 2009.

Note: This adjustment does not result in a difference in basis of the affected assets for state and federal income tax purposes. Even if the taxpayer subsequently sells the affected asset in 2009 or thereafter, the taxpayer still is allowed to deduct 20% of the total 2008 tax add back over the next five (5) years.

Note: The NC Department of Revenue states that it will apply the Announcement it issued on March 7, 2006 to the new bonus depreciation rules. This Announcement, discussed below, discusses the bonus depreciation deduction for pass through entities. This announcement also advised 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

IV. <u>Department of Revenue Issues Announcements Regarding Bonus Depreciation Deductions Under the Federal Job Creation and Workers Assistance Act of 2002 or the Federal Jobs and Growth Tax Relief Reconciliation Act of 2003</u>.

A. <u>General</u>. 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.

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

V. Changes in Franchise Tax Involving Corporate-Affiliated LLCs.

A. **Background.** 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. **2001 Tax Law Amendments.** 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. **2004 Tax Act Amendments.** 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) Use of A Partnership Between the Corporate Parent and Subsidiary LLC. 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) Convert a Corporation to an LLC and Then Make An Election to Have the LLC Taxed As a Corporation. 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 2007 North Carolina Law For LLCs That Elect To Be Treated As C Corporations. 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. Now, As Of January 1, 2009, LLCs That Elect To Be Taxed As S Corporations Also Are Covered Under the New Rules! The 2006 franchise tax changes only specifically applied to Corporations that convert to an LLC and that then elect to be taxed as a C Corporation. So, there was a perceived "loop-hole" 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.

However, HB 2436 (2008) has closed this loop-hole to now provide that LLCs, which elect to be taxed as S corporations for federal income tax purposes will now be subject to the North Carolina franchise tax.

Effective Date. This amendment is effective for tax years beginning on or after January 1, 2009. Because the franchise tax imposed under N.C.G.S. 105-122 is for the tax year in which the tax becomes due, this amendment will impact the franchise tax reported on the 2008 income and franchise tax return, since it is due on April 15, 2009.

N.C.G.S. 105-114(a)(5) as amended by H.B. 2436

H. Finally, 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.

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

A. <u>Introduction and Background</u>. 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. <u>Allowable Options for Trademark Royalty Payment Reporting</u>. 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.

> **<u>Note: Who are "Related Parties?"</u>** 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. <u>New 2006 Patent and Copyright Royalty Reporting Rules</u>. Under 2006 Senate Bill 1741, the North Carolina corporate income tax trademark royalty reporting requirements are **extended** to apply to royalties received from <u>patents</u> **and** <u>copyrights</u>, 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. <u>Transfer of Accounts</u>. 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. <u>The "Blended" ESC Tax Rate</u>. 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: Refunds May be Available for Certain Purchases Through Bankruptcy. 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 refund of excess SUTA taxes paid after August 1, 2003.

D. Remember the "Break in Service" Concept. 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 outside 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 unless 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
TAX COLLECTION PROCEDURE: AUDITS, STATUTES OF LIMITATION AND NORTH CAROLINA DEPARTMENT OF REVENUE COLLECTION PROCEDURES

I. <u>Quicker Tax Assessment For Returns Filed Without Tax Payment</u>.

The North Carolina Department of Revenue (DOR) has announced that it will send out Final Notices of Taxes Due approximately 45 days faster than in the past to taxpayers who submit North Carolina personal income, personal income tax withholding, corporate income, corporation franchise, and sales and use tax returns that show tax owed but who do not pay the tax.

As a result of recent legislative changes in 2008, the DOR no longer is required to send proposed assessments to taxpayers who submit returns without paying the tax due. The old proposed assessment notice gave the taxpayers a chance to respond to the tax due amount and to possibly request a conference or hearing about the taxes, which typically resulted in a delay of at least 45 days before the taxpayer received a final notice and paid the taxes.

The DOR stated that last year, there were approximately 479,000 returns that would have qualified for this accelerated collection process. About 47% were individuals (D-400 returns), with 53% coming from businesses (including sales and withholding returns), which means the change will impact both individual taxpayers and businesses.

NCDOR *Communication*: *Final Tax Assessments Going Out Sooner*,
North Carolina Department of Revenue, July 20, 2009

II. <u>New Withholding Required For Payments to Contractors With ITINs</u>

Effective Jan. 1, 2010, any "payer" that pays more than $1,500 to an independent contractor who holds an Individual Taxpayer Identification Number (ITIN) must withhold 4 percent of that pay. ITINs are issued by the Internal Revenue Service to individuals who are not eligible to receive a social security number. Payers include businesses, organizations or other individuals.

This new law does not apply to wage compensation from which state and federal income taxes are already being withheld. So, ITIN holders, who are paid as employees as opposed to independent contractors and who already have state and federal taxes withheld from their pay, are not subject to additional withholding.

Payers should file and pay withholding taxes on contractors with ITINs just like they would for regular employees (using the same online process or forms and the same filing and paying frequency). Payers that are subject to this new withholding requirement, and that don’t currently file and pay withholding taxes, must register with the state and receive a withholding account number so they can begin filing and paying the taxes.

Chapter 476 (S.B. 1006, Laws 2009).

III. Responsible Person Liability for Trust Fund Taxes

A. Background. Individual officers and directors of a corporation are usually not liable for corporate debts or obligations. General partners of a partnership, on the other hand, are always personally liable for debts and liabilities of the partnership.

B. "Responsible Person" Liability Under N.C.G.S. 105-242.2. However, by statute, a "responsible officer" of a corporation or a limited liability company may be held personally liable for certain unpaid "trust taxes" owed by the business entity, such as sales and use, motor fuels, and income withholding taxes. A "responsible officer" is defined as any of the following:

(i) the president, treasurer, and the CFO of a corporation,

(ii) the manager of an LLC, and

(iii) any other officer of a corporation or a member of a LLC who has a duty to pay trust taxes on behalf of the entity.

Note: This statute was amended in 2007 to **add CFOs** to the list of persons who are automatically deemed "responsible persons."

C. Now, Partners Are Added to the List of "Responsible Persons." Prior to 2008, there was no similar statutory provision to assess partners for these taxes. Instead, the Department of Revenue, like any other creditor of a partnership, had to sue the partners in order to collect this liability against the partners of a partnership. Once a judgment was obtained, the Department of Revenue had to seek to execute the judgment.

New Senate Bill 1704 (2008) amended N.C.G.S. 105-242.2 to **add general partners** of a partnership to the list of "responsible persons."

Note: SB 1704 also recodified N.C.G.S. 105-253 as new N.C.G.S. 105-242.2.

Effective Date: This change becomes effective July 1, 2008, and applies to taxes that become collectible on or after that date.

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

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

V. G.S. 105-264 - Effect of Secretary's Interpretation Resulting in Erroneous Verbal or Written Advice

This statute was rewritten to provide that a taxpayer is not liable for any penalty or additional tax assessment attributable to erroneous advice, either in writing or verbal, furnished by the North Carolina Department of Revenue when **all** of the following conditions are satisfied:

(1) The advice was reasonably relied upon by the taxpayer,

(2) The penalty or additional assessment did not result from the taxpayer's failure to provide adequate or accurate information, **and**

(3) The Department provided the advice in writing **<u>or</u>** the Department's records establish that it provided erroneous **<u>verbal</u>** advice.

(Effective July 16, 2008; HB 2436, s. 28.16(e), S.L. 08-107.)

VI. N.C.G.S. 105-258.2 - North Carolina Department of Revenue Must Document Taxpayer Conversations in Certain Circumstances. (All Taxes)

This is a new statute requiring the Secretary to document advice given to a taxpayer - in a conversation between a taxpayer and an employee of the Department of Revenue that is conducted by telephone or in person and occurs at an office of the Department if the conversation is in person - if the taxpayer requests such information to be documented in the taxpayer's file. This new requirement does not apply to a conversation occurring at a presentation, a conference, or another forum.

The taxpayer must give the Secretary the taxpayer's identifying information, ask the Secretary about the application of a tax to the taxpayer in specific circumstances, and request that the Secretary document the advice in the taxpayer's records. The documentation may be an entry in the account record of the taxpayer or by another method determined by the Secretary; it must set out the date of the conversation, the question asked, and the advice given.

(Effective January 1, 2009; HB 2436, s. 28.16(c), S.L. 08-107.)

VII. N.C.G.S. 105-258.2 - North Carolina Department of Revenue Must Document Taxpayer Conversations in Certain Circumstances (Sales Tax)

This new section was amended to add a new subsection for advice related to sales tax. It requires the Secretary to document advice given in a conversation with a person who is not registered as a retailer or a wholesale merchant when the person gives his name and address, describes a business in which he is engaged, asks if he is required to be registered, and requests that the advice be documented. The record of the person's inquiry must include the date of the conversation, the person making the inquiry, the business described in the conversation, and the advice given.

(Effective July 1, 2009; HB 2436, s. 28.16(d), S.L. 08-107.)

VIII. North Carolina Department of Revenue Plans to Record Department of Revenue Taxpayer Advice.

The Department of Revenue is directed to establish a plan for recording telephone calls received at the Taxpayer Assistance and Collection Center. The plan must be implemented by July 1, 2010 and must provide for recording calls for the purpose of training and evaluation with respect to customer service and quality control measures.

(Effective July 16, 2008; HB 2436, s. 28.16(g), S.L. 08-107.)

Note: These changes are made under House Bill 2436 and they are effective July 16, 2008 but they expire January 1, 2010.

IX. <u>2007 New Procedure for Department of Revenue Appeals</u>

A. <u>Background and Summary of Pre-2008 Appeals Rules</u>. 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. <u>New Department of Revenue Appeal Procedures Applicable After 2007</u>. 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.

X. 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.

XI. 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.

XII. 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!

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

XIII. <u>Project "Collect Tax": Continued Outsourcing of Tax Collection Efforts</u>.

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.

XIV. <u>"Project Collect Tax" Surpasses its Goals</u>.

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.

XV. <u>Beware of Increased Focus on Corporate Non-Filers</u>.

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.

XVI. <u>**Increased Focus on Tax Protestors and Non-Filers**</u>.

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.

XVII. <u>**North Carolina Department of Revenue Launches "Project Compliance**</u>**."**

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 <u>**informal discussions**</u> 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).

XVIII. 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. Summary of Voluntary Disclosure Program. Here is a summary of the new Voluntary Disclosure Program taken from the North Carolina Department of Revenue website:

Description of Program

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.

XIX. <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. <u>2009 Changes to the Offer In Compromise Rules</u>. HB 2436 (effective July 16, 2008) has modified N.C.G.S. 105-237.1 which authorizes the Secretary of Revenue to compromise the amount of a taxpayer's liability (Offers in Compromise). Portions of the following are reproduced from North Carolina Department of Revenue Explanation of 2008 Tax Law Changes.

1. <u>Insolvency</u>. The finding, pertaining to a taxpayer's claimed insolvency, was rewritten to clarify that a taxpayer is considered "insolvent" <u>only</u> if (i) it is plain and indisputable that the taxpayer is clearly insolvent and will remain so in the reasonable future, **or** (ii) the taxpayer has been determined to be insolvent in a judicial proceeding (such as a bankruptcy court).

2. **Unjust Result Circumstances.** A new finding was added and provides that a taxpayer's liability may be compromised if collection of a greater amount than that offered in compromise would produce an **"unjust result"** under the circumstances. The former provision - which specifically related to compromising an assessment based upon an action of the federal government in making an assessment which is subsequently settled, compromised, or adjusted - was deleted.

Note: The purpose of the new subsection is to allow for an avenue of relief in special circumstances, such as (i) where the North Carolina Department of Revenue somehow contributed to the tax liabilities (such as through incorrect verbal advice) or (ii) where the taxpayer is undergoing a special life challenge (such as a disease).

3. **Certain Review by Secretary of Revenue.** A new provision requires that, for a compromised tax liability of at least $1,000.00, the Secretary must make a written statement setting out the amount of the liability, the amount accepted under the compromise, a summary of the facts concerning the liability, and the findings on which the compromise is based. The Secretary must sign and keep a record of the statement. If the compromise settles a dispute that is in litigation, the Secretary must obtain the approval of the Attorney General before accepting the compromise. and the Attorney General must sign the statement describing the compromise; for other compromise settlements, approval of the Attorney General is not required.

4. **Effective Date.** The new OIC rules are effective as of July 16, 2008.

D. **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.

XX. 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.

XXI. 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 month 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.

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. Good Compliance Record Reason Under General Waiver Criteria.

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.

XXII. 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).

XXIII. Filing Tax Return Extension Request Will Not Always Prevent Late Filing and Late Tax Payment Penalties.

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.

XXIV. Separate North Carolina Extension Forms Must Be Filed for Individual 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 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.

XXV. 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.

XXVI. 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 <u>all schedule</u> 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.

XXVII. 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.

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