NOVEMBER 2010
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 **November 1, 2010**, 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 Surtax Will Also Apply for 2010 But Will Expire for 2011.

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 Continues For 2009 and 2010 And Expires January 1, 2011. 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 for 2009 and 2010, 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. North Carolina Partially Conforms to the Federal 5 Year Carryback of 2008 and 2009 Net Operating Loss (NOL) Rules.

A. Overview of 2009 NOL Federal Legislation.

1. The Federal ARRA: 5 Year Carryback for 2008 NOLs for Small Businesses. On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act (ARRA). Under the ARRA, an Eligible Small Business (ESB), as defined by § 172(b)(1)(H) of the IRS Tax Code, could elect to carry back an NOL from the **2008 tax year** for 3, 4 or 5 years rather than the standard 2 years. An ESB is defined in § 172(b)(1)(H) of the IRS Tax Code. Under the ARRA, an ESB is a corporation or partnership with less than $15 Million in gross receipts for the loss tax year.

2. The Federal WHBAA: 5 Year Carryback for 2008 and 2009 NOLs For All Businesses. On November 6, 2009, President Obama signed into law the Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA). This law modified the ARRA by allowing businesses of **every size** (and not just an ESB) to carry back 2008 or 2009 NOLs for up to 5 years. So, as part of the WHBAA, Congress not only extended the benefit of the 5 year NOL for an additional year, but also extended the scope of the benefit by **removing** the ESB small business limitation. **In other words, the WHBAA, allows all taxpayers, whether an ESB or not, to carry back 2008 and 2009 NOLs 3, 4, or 5 years** (subject to a 50% federal taxable income limit on NOL carrybacks to the fifth year).

However, the expanded election under the WHBAA is available for NOLs incurred during either 2008 or 2009 **but not for both years**, unless the carryback election is made by an ESB. So, there is an exception for an ESB. This means that an ESB, that elected to carry back its 2008 NOL under the ARRA, may **also** make the election available under the WHBAA for a 2009 NOL, enabling the ESB to carry back NOLs from both 2008 in 2009 for up to 5 years.

B. New 2009 NC Legislation Allows 5 Year Carryback of 2008 NOLs For ESBs.

Last year, Governor Perdue signed Senate Bill 202 on August 9, 2009, and updated the NC tax references to the IRS Code enacted as of May 1, 2009. Therefore, North Carolina law adopted the 5 year Net Operating Loss carry back provisions for 2008 Net Operating Losses for an ESB as allowed by the ARRA signed by President Obama on February 17, 2009.

Note: A North Carolina taxpayer is required to carry back a 2008 NOL to the same year for federal and state income tax purposes. N.C. Department of Revenue Announcement, August 14, 2009.

C. **<u>New 2010 North Carolina Legislation</u>.** Governor Perdue signed Senate Bill 897 on June 30, 2010, which updates the North Carolina references to the IRS Tax Code as of May 1, 2010. N.C.G.S. 105-228.90(b)(1b). However, Senate Bill 897 also requires certain adjustments to the federal taxable income. Under new N.C.G.S. 105-135.6(d)(7), a North Carolina taxpayer (other than an ESB) is required to **add back**, to federal taxable income, the amount of any 2008 or 2009 NOL claimed under the WHBAA beyond the standard 2 year carryback period. However, no addition to federal taxable income is required for the portion of a NOL that is attributable to an ESB as defined by § 172(B)(1)(H) of the IRS Tax Code. **So, only North Carolina ESBs can utilize the benefits of 2008 NOLs and 2009 NOLs more than 2 years.**

Note: A North Carolina taxpayer is required to carryback a 2009 North Carolina NOL to the same year for both federal and North Carolina tax purposes.

D. **<u>Other Adjustments to 2011-2013 North Carolina Taxable Income</u>.** N.C.G.S. 105-134.6(d)(8) also was amended to provide that, for taxable years 2011 through 2013, any taxpayer who made an addition to taxable income under (d)(7), can then deduct 1/3 of the NOL add back required on their 2003, 2004, 2005, 2006 tax returns for tax years 2011, 2012 and 2013. So, under new N.C.G.S. 105-134.6(d)(8), there are future deductions from the NOL addition required under NCGS 104-134.6(d)(7). Under the new rules, a deduction for one-third (1/3) of the 2008 NOL or the 2009 NOL is allowed for the tax years 2011, 2012, and 2013.

SB 897, effective June 30, 2010.

For a further discussion of the new 5 year carry back rules for 2008 and 2009 NOLs, see Personal Tax Division Notice dated August 27, 2010, entitled "Update on State Tax Treatment of 5-year Carryback of 2008 and 2009 Net Operating Losses."

III. <u>2009 Legislation Provides for New Personal Income Tax Add-Backs</u>

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 <u>standard deduction</u> for state and local real property taxes; and
2. federal deduction for motor vehicle sales and use tax.

IV. <u>Individual Income Tax Add Back for Federal Accelerated Bonus Depreciation.</u>

A. <u>Introduction.</u> 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. <u>New Add Back</u>. 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.

V. <u>Individual Future Deductions for Special Accelerated Depreciation Add Back</u>.

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 <u>future</u> 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.

VI. <u>Extension of Use Tax Line on Personal Income Tax Returns</u>.

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.

VII. 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.

VIII. 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.

IX. No Personal Income Tax Deductions Allowed for "Hobby Losses" Relating to Dog Breeding/Showing Activity.

A. Introduction. 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. <u>N.C. Secretary of Revenue Decision 2007-101</u>. 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.

X. <u>When is a Person a Resident of North Carolina</u>?

The Secretary of Revenue issued two decisions in 2003 regarding in-state versus out-of-state residency.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

6. Effective July 2001, the husband accepted a temporary three-year job assignment in another country from his employer. This assignment ended prematurely in September 2001 and the husband was reassigned to another state. During this

time, the husband traveled extensively on business from North Carolina to another state and to another country and would most often return to his wife at home in North Carolina. While temporarily assigned to another country, the employer continued to maintain the husband on the North Carolina payroll of the employer. The husband's employment with the employer ended on March 8, 2002.

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

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

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

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

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

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

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

14. Withholding reports for the husband's self-employment accounting business were filed by husband for all four quarters during 2001 showing a North Carolina business address. The reports also listed taxpayer's North Carolina home telephone number. The North Carolina Annual Withholding Reconciliation Report reflected the North Carolina business address.

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

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

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

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

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

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

PART TWO
PROPERTY TAX DEVELOPMENTS

I. <u>New Property Tax Deferral for Builders Who Hold Real Property For Sale to Customers</u>.

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 <u>after July 1, 2010</u>, 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

II. <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, and (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.

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. 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).**

II. 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. <u>North Carolina Only Partially Conforms with Federal Estate Tax Law In Effect for 2008 and 2009</u>. 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 <u>before</u> applying the percentage reduction to the federal credit.

> **NOTE**: Until the General Assembly further changes the law, the amount of North Carolina estate tax imposed under North Carolina law will continue to be the **maximum credit for state death taxes** allowed under section 2011 of the Code **as of January 1, 2001**. This

means that it may be **less costly** to die a resident of another state which limits the state death tax to the amount of the federal state death tax credit that is actually allowable for federal estate tax purposes for the year of death.

C. <u>As of Now, There Is No Federal 2010 Estate Tax</u>.

III. <u>New Due Dates for Filing An Amended North Carolina Death Tax Return After Federal Redetermination</u>.

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!

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

IV. <u>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</u>.

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. <u>Introduction and Background</u>. 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. Increased General Sales Tax Rate Expires July 1, 2011

Effective October 1, 2009, the **general state rate** of sales and use tax is "temporarily" **increased** to 5.75%.

The local county tax rate **decreases t**o 2% 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 expire **on July 1, 2011**. N.C.G.S. 105-164.4(a).

II. New 2010 Sales and Use Tax Compliance Relief For Certain Small Retailers.

A. Background. Before 2010, N.C.G.S. 105-164.16(b1) provided that any taxpayer, who was consistently liable for at least $100, but less than $10,000, a month in state and local sales and use taxes, must file a return and pay taxes on a **monthly basis.**

In addition, under N.C.G.S. 105-164.16(b2), if a taxpayer was consistently liable for at least $10,000 a month in state and local sales and use taxes, then that taxpayer was required to make a monthly **prepayment** of the next month's tax liability equal to 65% of the tax due for the current month. This monthly sales tax burden was a great burden upon many small retailers.

So, under these "old" rules, retailers were required to pay sales and use tax on one of three filing schedules:

1. A retailer, who was consistently liable for less than $100 a month in sales and use taxes, would file sales and use tax returns on a ***quarterly basis***.

2. A retailer, who was consistently liable for at least $100, but less than $10,000 a month, in sales and use taxes had to file a return and pay sales and use taxes due on a ***monthly basis***.

3. A retailer, who was consistently liable for at least $10,000 a month in sales and use taxes, had to make a monthly **prepayment** of the next month's tax liability equal to 65% of the current month's sales and use tax liability.

B. New 2010 and 2011 Sales Tax Relief for Certain Small Businesses. New S.B. 897 provides a **two (2) year phase-in** of additional relief for small businesses by (1) increasing the threshold for monthly sales and use tax filers and (2) increasing the threshold for retailers who must prepay 65% of the next month's sales and use tax liability.

C. 2010 Relief for Small Retailers.

1. New 2010 Minimum Threshold For Monthly Filers. Under a new revised N.C.G.S. 105-164.16(b1), the monthly sales and use tax filing threshold for a retailer is now $15,000 - which is increased from $10,000 a month. **Now, the monthly filing requirement only applies to retailers who consistently have sales tax liabilities of $15,000 or more.** This change is effective October 1, 2010.

2. New Minimum Thresholds for 65% Prepayments for 2010. Under new N.C.G.S. 105-164.16(b)(2), retailers will only have to prepay 65% of the next month's sales tax liability if their sales tax liabilities are consistently in excess of $15,000 per month - which is increased from $10,000 a month. This change is effective October 1, 2010.

D. 2011 Relief for Small Retailers.

1. New 2011 Minimum Threshold for Monthly Filers. Beginning on October 1, 2011, the monthly sales tax filing requirements will only apply to retailers who consistently have sales tax liabilities of over **$20,000 per month**.

2. New 2011 Threshold for Prepayment Obligations. Likewise, beginning October 1, 2011, the 65% monthly prepayment obligation will only apply to taxpayers who consistently have at least **$20,000 per month** in sales and use tax liabilities.

Note: These new changes are predicted to reduce the amount of revenue received in 2010-2011 by $7 Million, and the amount of revenue received in 2011-2012 by $12 Million.

III. Sales and Use Tax Now Payable on Certain Online Purchases of Digital Download Items.

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.

IV. 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.

V. 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.

VI. 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, until 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**: Purchasers Are Also Liable for Unpaid Sales and Use Taxes of Seller. 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 greater 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.

VII. Reduction of Certain Sales Tax Assessments Against Small Businesses; New N.C. G.S. 105-244.2

A. Introduction. 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 **requires** 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. Review of New N.C.G.S. 105-244.2. 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 part of the assessment, when the assessment is made as the result of an **audit** of the **small business** and **all** 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. **New Corporate Income Tax Surtax for 2009 and 2010 Expires in 2011**

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."

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

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

II. New Reduced Corporate Franchise Tax Burden for Certain Construction Companies.

A. Background and Introduction. The state franchise tax, assessed on C Corporations and S Corporations, is determined based upon a company's capital stock, surplus and undivided profits. Under N.C.G.S. 105-122(b), the term "surplus and undivided profits" includes all liabilities, reserves and deferred credits, except to the extent that any of these items are specifically exempt.

One of the specific exemptions from the definition of "surplus and undivided profits" are "definite and accrued legal liabilities." N.C.G.S. 105-122(b)(1). The North Carolina Department of Revenue has defined a "definite and accrued legal liability" as a liability that is definite in amount (and not merely estimated).

B. Review of Percentage of Completion Accounting Method For Certain Construction Contractors. Under GAAP, revenue is recorded when it is earned - regardless of when the work is billed for, or when payment is received. With construction contracts, billed revenue and earned revenue can occur at different times. So, under GAAP, to alleviate this possible mismatch of billed and earned revenue, contractors may use the "percentage of completion method" of accounting in those cases where construction costs can be reasonably estimated.

Under this "percentage of completion" accounting method, as long as construction costs can be reasonably estimated, construction revenue is recognized as production takes place. However, since revenue recognition and actual billing may occur at different times, the "percentage of completion contract method" may result in "billings in excess of costs" or "costs in excess of billings." For balance sheet purposes, any amounts of "billings in excess of costs" will be a liability because this figure represents income that is yet to be earned. On the other hand, any amount of "costs in excess of billings" would be a balance sheet asset.

C. Prior N.C. Franchise Tax Law Required "Billings In Excess of Costs" To Be Included in Franchise Tax Base. Under previous North Carolina law, for purposes of calculating a corporation's franchise tax base, the North Carolina Department of Revenue took the position that, under N.C.G.S. 105-122(b)(1), the balance sheet liability amount (represented by "billings in excess of costs") was **not** considered to be a "definite and accrued legal liability" under the "percentage of completion contract method" of accounting, since that amount was based upon future construction cost estimates. Therefore, the amount of "billing in excess of costs" was considered to be a part of "surplus and undivided profits" and thus was included in the corporation's capital basis and thus was subject to North Carolina franchise tax.

Many members of the construction industry thought that this was unfair treatment to them because those contractors would have to pay North Carolina franchise tax on revenue that had not yet been earned by the contractor.

D. 2009 Franchise Tax Changes For Certain Construction Contractors Who Use the Percentage of Completion Accounting Method; New N.C.G.S. 105-122(b)(1a). In 2009, N.C.G.S. 105-122(b)(1a) was revised to provide that "billings in excess of costs" under the percentage of completion accounting method are exempt from the definition of "surplus and undivided profits." Thus, this balance sheet liability will no longer be subject to the North Carolina franchise tax.
N.C. Sess. Laws 2009-422.

E. Effective Date and Possible Refund Claims for 2007, 2008 and 2009. The new Act becomes effective January 1, 2010. However, this new law is retroactive to 2007, which means that any taxpayer, that paid franchise tax in 2007, 2008 or 2009 on "billings in excess of costs," can apply for a refund of those extra franchise taxes paid. N.C. Sess. Laws 2009-422, Sec. 31.9.(a). However, any requests for a refund for 2007, 2008 or 2009 franchise taxes must be made on or before January 1, 2011; any refund request after that date will be barred. N.C. Sess. Laws 2009-422, Sec. 31.9.(b).

III. New 2010 Relief for Annual Report Compliance.

A. Background and Introduction. North Carolina corporations and LLCs are required to file annual reports each year and to pay the required annual report fee. For a business corporation annual report filed online, the corporate annual report fee is $18 plus a $2 electronic transaction fee. If filed in paper form with the Department of Revenue, the North Carolina corporation annual report fee is $25. A Limited Liability Company and Limited Liability Partnership annual report fee is $200 plus the $2 electronic filing fee.

Occasionally, we have had clients who have gotten behind in filing their annual reports. The scary thing is that, if a corporation or LLC fails to file its annual report, the failure to file an annual report can be grounds for administrative dissolution of the corporation or LLC.

B. In 2009, North Carolina Secretary of State Advises of Numerous Annual Report Delinquencies. In March 2009, the North Carolina Secretary of State's office mailed 270,000 notices to businesses stating that they were late in filing one or more annual reports.

For example, the Secretary of State had found that many LLCs thought that their first annual reports were due the year after their formation. The Secretary of State, however, informed the LLCs that their first annual report was due on April 15 regardless of when the business was formed. This meant that, if an LLC was formed on April 10, then the same LLC also would have to file an annual report five days later on April 15.

Many CPAs and other practitioners were unaware of this annual report filing requirement for LLCs, and so we had a lot of LLCs that had failed to file their first annual report for the year of formation that proceeded April 15. Not surprisingly, many CPAs complained about the annual report compliance notices sent to many small business clients.

C. New North Carolina Annual Report Compliance Changes. New SB 875 has now made the following changes to the NC Secretary of State annual report filing notice requirements:

1. Due Date for Corporate Annual Reports Is the Same Date For Filing the Corporate Income Tax Return. First, under the new amended N.C.G.S. 55-16-22(c), the new due date for filing annual reports for a corporation will now be the same as the due date for filing corporate income tax returns – the 15^{th} day of the fourth month following the corporation's year end. New amended N.C.G.S. 55-16-22(c); SB 897.

2. First Annual Report For An LLC Will Be Due April 15 of the Next Year. Second, for newly formed LLCs, the first annual report required to be filed by an LLC will now be due by April 15 of the year **following** the calendar year in which the LLC files its Articles of Organization. Amended N.C.G.S. 57C-2-23(c).

3. New Retroactive Relief For LLC Annual Reports for LLCs Formed After September 2001. Also, the statutory changes further provide for some "retroactive relief" for certain LLCs formed after September 1, 2001, and now provide that an LLC is considered to have timely met its annual report filing obligations if:

(1) the LLC was formed after September 1, 2001; and
(2) the LLC has filed its annual reports for each year **after** the calendar year in which its Articles of Organization were filed.

This retroactive relief will help LLCs formed during the first three months of a year after 2001, and who failed to file an annual report by April 15 of the year of formation. Also, under the new rules, an LLC formed after January 1, 2010, but before April 15, 2010 is not required to file an annual report until April 15, 2011.

N.C. Sess. Laws 2010-31, Section 31.4.(c), effective July 1, 2010.

Note: The estimated loss to the General Fund for fiscal year 2010-2011 is $400,000.

IV. 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.

PART SIX
NEW ESC UNEMPLOYMENT TAX RULES

I. "Temporary" 2010 and 2011 Small Business Refundable Tax Relief for Certain Payments to North Carolina Unemployment Insurance Fund.

A. Background. The North Carolina Unemployment Insurance Tax is a tax on employer payrolls paid by employers, and these funds are then used to provide funds from which unemployment benefits are paid to qualified unemployed workers. The unemployment insurance tax is not deducted from employee wages, but instead is a direct tax against the business-employer.

B. New North Carolina UI Credit for 2010 and 2011 For Small Businesses. New 2010 Senate Bill 897 has provided a new § N.C.G.S. 105-129.16J, which now allows a **new tax credit** for "small businesses" that make contributions to the North Carolina Unemployment Insurance Fund. The new tax credit is equal to 25% of the qualified contributions to the North Carolina Unemployment Insurance Fund. **This temporary credit only applies to taxable years 2010 and 2011. N.C.G.S. 105-129.16J(c).**

C. Refundable Credit Can Only Be Claimed Against Income Taxes. This new UI credit may be claimed only against corporate and individual income taxes (and not sales or property taxes). New N.C.G.S. 105-129.16J(b)(1). However, this credit is a refundable credit - which means that, if the amount of the 25% credit exceeds the amount of the corporate and individual income taxes for the year, the excess will be refunded to the taxpayer. New N.C.G.S. 105-129.16J(b)(2).

D. But What is a Small Business? A small business is a business whose cumulative gross receipts from business activities for the taxable year do not exceed $1 Million. New N.C.G.S. 105-129.16J(a).

Note: The estimated cost of this change to the General Fund for fiscal year 2010-2011 is $34.1 Million.

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

I. NC Officially Adopts the "Mailbox Rule" for Certain Filings, Refund Claims and Requests For Review of Proposed Assessments.

A. Background and Introduction. The NC tax rules have been confusing - to say the least - in determining when the NCDOR was deemed to have received a taxpayer filing or refund claim. This issue has been especially troublesome for taxpayers filing a refund claim or filing a request for a Departmental Review of a proposed assessment. Also, clients have wondered whether a filed return, report, payment or a request for an extension of time for filing a report or return would be timely - depending upon when the return, payment or extension request was mailed or received by the NCDOR. Except with respect to filed Requests for Review of Proposed Assessments or Denial of Refund Claim, the NCDOR in the past appeared to have informally adopted the federal "mailbox rule."

B. New Mailbox Rule for Filing a Return, Report or Payment or Requesting Extensions. The NC tax rules have now officially adopted the "mailbox rule." N.C.G.S. 105-263 has now been amended to provide that, for purposes of determining whether a return, report or payment or other document is timely filed, Section 7502 of the Internal Revenue Code now governs when a return, report, payment or any other document is deemed to be filed with the NCDOR. So, new N.C.G.S. 105-263 now provides that IRC Section 7502 of the IRS Tax Code now governs when a return, report, payment or any other document that is mailed to the NCDOR is now deemed to be timely filed. New N.C.G.S. 105-263(a).

This Section 7502 of the IRS Tax Code is known as the “mailbox rule.” Under the mailbox rule, the date the document is considered "filed" is the United States postmark date stamped on the **mailing cover** in which the return, report, payment or other document is mailed. Therefore, under the new North Carolina rules, a report or return or payment is deemed filed when it is mailed rather than when it is received by the NCDOR.

Effective July 17, 2010; Senate Bill 1177.

C. New Mailbox Rule for Requests for Review of a Proposed Tax Assessment or a Proposed Denial of Refund Claim. In addition, N.C.G.S. 105-241.11(b) is also revised to provide that a request for a Departmental Review of a proposed tax assessment or proposed denial of a refund claim is considered to be filed on the following dates:

(1) For a request delivered in person, the date of delivery;

(2) For a request that is mailed, the date determined in accordance with N.C.G.S. 105-263 (i.e., the "mailbox rule"); and

(3) For a request delivered by any other method, the date the Department receives it.

Effective July 17, 2010, SB 1177, Session Law 2010-95.

II. Attachment and Garnishment.

A. Now, North Carolina Garnishment Notices May Be Sent by Electronic Means. New 2010 SB 897 amended N.C.G.S. 105-242.1 to now permit the NCDOR to send notices to a garnishee by electronic means. This will speed up the process by which a garnishee has been provided notice of a taxpayer's outstanding tax liability.

B. New Data Matches Between the NCDOR and Financial Institutions Will Speed Up Garnishment of Bank Accounts of Delinquent Taxpayers. Effective January 1, 2011, SB 897 now provides that the NCDOR may submit a quarterly statement to any financial institution regarding information identifying taxpayers and the amount of debts owed by that taxpayer to the NCDOR. The financial institution will then search its records and will then inform the NCDOR as to whether any taxpayers have accounts at that financial institution. This new matching program will increase the speed of garnishments for bank accounts held by taxpayers at various financial institutions.

New amended N.C.G.S. 105-242(b).

III. NCDOR Will Increase Collections by Expanding the Use of the "Set Off Debt Collection Act" For North Carolina Tax Refunds.

The Set Off Debt Collection Act, which was enacted in 1997, allows the NCDOR to "set off" an **individual's** income tax refund against a debt that individual owes to NC. Under that Act, a claimant agency of NC sends the NCDOR notice of the debt owed by the individual taxpayer and the NCDOR immediately sets off the debt the individual owes to North Carolina against any tax refunds that North Carolina owes to that individual taxpayer.

These rules have now been expanded to allow debts that a business **or** individual owes to a NC agency to be set off against that entity's North Carolina tax refund. N.C.G.S. 147-86.25 and N.C.G.S. 105A-2.

Note: The Set-off Debt Collection Act also was expanded to now apply to any type of tax refund and not just an income tax refund. New N.C.G.S. 147-86.25(2).

Subsections (d) through (g) of Section 31.8 of Session Law 2010-31.

IV. <u>Expansion of Statewide Accounts Receivable Program</u>.

A. <u>Background and Introduction</u>. The Statewide Accounts Receivable Program was enacted in 1993. This Program requires the North Carolina State Controller to monitor accounts receivable owed by North Carolina taxpayers to North Carolina state agencies.

Subsections (a) through (c) of Section 31.8 of Session Law 2010-31 have modified the Statewide Accounts Receivable Program, and N.C.G.S. 147-86.20 through 147-86.25, to allow North Carolina tax debts owed by a North Carolina taxpayer to be "set-off" against payments that North Carolina owes to that taxpayer, either for goods or services that the North Carolina taxpayer previously provided to North Carolina.

For example, let's assume that a North Carolina general contractor owes back taxes to the North Carolina Department of Revenue and has provided services to the State of North Carolina. Under the expanded Statewide Accounts Receivable Program, before the NC State Controller issues payment to that contractor, the Controller will check to see if the contractor owes any tax debts to the NCDOR. When the Controller determines that a tax deficiency is owed to the NCDOR, the account payable owed by North Carolina to the contractor will be "set-off" by the amount of the tax debt the taxpayer owes to the NCDOR.

Subsections (a) through (c) of Section 31.8 of Session Law 2010-31.

V. <u>New NCDOR Guidelines For Reviewing And Accepting Offers In Compromise</u>.

A. <u>Background and Introduction</u>. N.C.G.S. 105-237.1 provides the North Carolina Department of Revenue with authority to entertain an Offer in Compromise under certain circumstances. Under N.C.G.S. 105-237.1(a), the NCDOR may accept an Offer in Compromise if the NCDOR determines that the compromise offer is in the best interest of NC and makes one of the following findings:

(i) there is reasonable doubt as to the amount of the tax liability (doubt as to liability);

(ii) the taxpayer is insolvent and the NCDOR probably could not otherwise collect an amount in excess of the offered amount (doubt as to collectability);

(iii) collection of a greater amount than offered is improbable and the funds offered for the OIC come from sources from which the NCDOR could not otherwise collect;

(iv) the IRS has already accepted an earlier OIC with respect to the same tax assessment and the NCDOR could probably not collect an amount equal to or in excess of that amount offered by the NC taxpayer; or

(v) collection of a greater amount than offered in the OIC would produce an unjust result under the circumstances.

B. **<u>NC Taxpayer Frustration With the NC OIC Process</u>.** We have heard of many NC taxpayers who have submitted NC OICs over the last several years based upon the Section 105-237.1 guidelines, only to have those OICs rejected for one reason or another. In many cases, NC practitioners have been frustrated with the lack of guidance offered by the NCDOR as to the specific amount that should be offered in a NCDOR OIC.

C. **<u>New NCDOR OIC Guidelines</u>**. The North Carolina Department of Revenue issued its new "Offer in Compromise Instruction Booklet" on February 2010 setting forth the guidelines for taxpayers to follow in submitting an OIC to the NCDOR. Under these new guidelines, an OIC will be considered **<u>only</u>** if **<u>all</u>** of the following criteria are met:

1. The taxpayer must have filed all tax returns legally required to be filed prior to submitting the OIC;

2. All estimated tax payments must be paid to date for the current year;

3. The taxpayer must submit a Form OIC-100 and RO-1062 or RO-1063 setting forth certain financial information regarding the taxpayer and his or her business; and

4. The taxpayer must offer to pay 20% of the amount offered in compromise as a non-refundable deposit when the offer is submitted. This 20% downpayment will not be refunded to the taxpayer – even if the OIC is rejected by the NCDOR – but this amount will be applied to reduce the taxpayer's outstanding tax liability.

D. **<u>Determining the Amount of Taxpayer's Offer and Required Downpayment.</u>** The new guidelines require that the taxpayer must submit an offer amount that equals the "reasonable collection potential" ("RCP") equal to the taxpayer's net equity in its assets **<u>plus</u>** estimated collection potential from future income. These guidelines are very similar to the guidelines currently entertained by the IRS in reviewing federal OIC offers for IRS tax purposes.

For further information regarding the new OIC guidelines for OIC purposes, see the "Offer in Compromise Instruction Booklet" published by the NCDOR in February 2010.

VI. <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

VII. New Withholding Required For Payments to Contractors With ITINs

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).

VIII. 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.

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

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

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

X. 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 **or** the Department's records establish that it provided erroneous **verbal** advice.

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

XI. 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.)

XII. 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.)

XIII. **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.

XIV. **North Carolina Department of Revenue Launches "Project Compliance."**

A new audit initiative for the Department of Revenue is called "Project Compliance." This new audit initiative challenges the Department of Revenue to collect over $100,000,000 of additional tax revenue in the next two years through the addition of thirty-nine new North Carolina Department of Revenue audit agents.

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

1. Bill Lee tax credits;

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

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

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

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

    a. Procurement companies;
    b. Management companies;

c. Factoring companies; and
d. Intellectual property companies.

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

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

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

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

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

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

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

13. Increased audit focus on Conservation Easement Donations;

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

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

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

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

18. Criminal Prosecution of Responsible Persons Who Fail to Pay Collected Sales Taxes and Withholdings Taxes. (See North Carolina Department of 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).

XV. 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.

XVI. <u>Innocent Spouse Relief Available for North Carolina Purposes</u>.

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.

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

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

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

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

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

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

(2) *No Outstanding Liabilities*: The taxpayer must have paid any tax and interest due for the period for which the penalty waiver is requested as well as any amount shown due on a final bill received for a tax period that is different from the tax period for which the penalty waiver is requested. Outstanding liabilities that are the subject of a hearing do not count; these liabilities are in dispute and have not been final billed. This condition is not tied to the look-back period or the tax type.

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

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

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

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

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

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

V. Action When Taxpayer Has Good Compliance Record

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

VI. Penalties Grouped for Waiver Under General Waiver Criteria

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

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

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

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

VII. Request to Waive Penalties

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

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

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

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

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

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

VIII. Grant or Denial or Request to Waive Penalties

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

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

XVIII. 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).

XIX. 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.

XX. 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.

XXI. 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.

XXII. General Discussion of New Unified Audit Procedures.

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

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

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

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

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

XXIII. 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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