

October 20, 2006

State & Local Tax Update

This North Carolina update discusses the legislative changes to North Carolina tax laws in the “short session” of 2006, as well as major appellate court cases and administrative developments from the Department of Revenue. The General Assembly adjourned the short session on July 28, 2006.

Corporate Income and Franchise Taxes

Legislative Developments

- **Corporate income tax: Reporting options for royalties received from intangible property**

North Carolina has expanded the reporting options for intangible property royalties. Formerly, taxpayers could only elect the reporting options available in N.C. Gen. Stat. § 105-130.7A for trademark royalties.

The reporting method alternatives that N.C. Gen. Stat. § 105-130.7A allows are either of the following: (1) the payer (property user) of the royalty payments may deduct them on its North Carolina return, and the recipient (property owner) of the payments may include them on its return; or (2) the payer may include the royalty payments on its return, while the recipient may deduct them on its return.

This reporting option has been expanded to all intangible property, including patents and copyrights, effective for taxable years starting on or after January 1, 2006. Sess. Laws 2006-66.

- **Adjustments to corporate income tax made inapplicable to S corporations**

Sess. Laws 2006-17 makes adjustments to corporate income taxes inapplicable to S corporations. The pro rata share of S corporation shareholders will no longer be adjusted as provided for in N.C. Gen. Stat. § 105-130.5, which requires an assortment of adjustments that North Carolina makes to federal taxable income for the purposes of determining the state net income of a corporation. S corporations remain subject to the provisions of N.C. Gen. Stat. § 105-134.6, which makes adjustments to shareholders' pro rata share of federal taxable income of S corporations. The fiscal note accompanying H.B. 1898 suggests that this change will simplify tax preparation and enhance compliance with the state tax laws. The change is effective for taxable years starting on or after January 1, 2006.

- **Conformity to the Internal Revenue Code**

As required under the state constitution, the General Assembly has passed its annual update to conform North Carolina's tax statutes to the Internal Revenue Code. This update was effective as of the date of ratification (June 21, 2006). Sess. Laws 2006-18.

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- **Deadline for filing amended returns after a federal correction shortened**

North Carolina now conforms to the model statute suggested by the Multistate Tax Commission regarding amended returns. The deadline for filing an amended return after a federal correction to taxable income has been shortened from two years to six months. This change applies to estate tax, gift tax, corporate income tax, and personal income tax. The six-month deadline applies to all federal determinations made on or after July 1, 2006. Sess. Laws 2006-18.

- **Deadline for nonresident corporate alien taxpayers**

North Carolina now requires that a corporation filing a federal return under I.R.C. § 6072(c) (i.e., a nonresident alien taxpayer) “shall file its return on or before the fifteenth day of the sixth month following the close of its income year.” N.C. Gen. Stat. § 105-130.17(g). This change means that nonresident alien corporate taxpayers may file their North Carolina return at the same time they file the federal return under I.R.C. § 6072(c). Previously, the North Carolina return for a nonresident alien had been due on or before the fifteenth day of the third month following the close of its income year, which was before the federal return had to be filed. The new deadline is effective for taxable years starting on or after July 1, 2006. Sess. Laws 2006-18.

- **Franchise tax base calculation**

In 1996, the Department of Revenue issued a Technical Advice Memorandum that provided that deferred tax liabilities could be included in the franchise tax base for the purpose of computing franchise tax liability to offset the assets set aside for such future tax liabilities. The Department came to believe that this ruling may not have been authorized by statute, so the General Assembly has codified the policy by amending the franchise tax statutory framework.

This act allows a corporation subject to the franchise tax to offset deferred tax assets with deferred tax liabilities for the purpose of computing the corporation’s base subject to tax. Deferred tax liabilities may only offset deferred tax assets; where liabilities exceed assets, the reduction in the corporate base cannot exceed the deferred tax assets. This new formula for calculating the franchise tax base will be effective for taxable years starting on or after January 1, 2007. Sess. Laws 2006-95.

- **Taxation of LLCs**

North Carolina has extended the corporate franchise tax to limited liability companies (LLC). The purpose of this change is to close a loophole in the tax code that allowed corporations to lower their franchise tax liability by transferring some or all of their assets to a wholly owned, single-member LLC. The new law imposes the franchise tax on LLCs and credits the difference between the annual report fees for corporations and LLCs, which pay higher annual report fees than corporations.

Notably, the General Assembly took action on this issue after the Department of Revenue received a request for a private letter ruling from an accounting firm on the subject and, according to the fiscal note to the House bill, made the General Assembly aware of the matter. The General Assembly is

not a stranger to tax planning using LLCs, having already addressed the matter several times since 2001. This change is effective on January 1, 2007. Sess. Laws 2006-66.

Judicial Developments

(None.)

Administrative Developments

(None.)

Trends/Outlook for 2006-2007

COST has organized a coalition to lobby for clarification of North Carolina law on forced combination of separate entity corporate tax returns and for reform of North Carolina's tax appeal system. The General Assembly's Revenue Laws Study Committee is studying these issues this fall and winter. Those interested in participating should contact Joe Crosby at 202-484-5225.

Sales Tax

Legislative developments

- **State sales tax rate drops**

Faced with a budget surplus in 2006, the General Assembly has cut the state sales tax rate by one-half of one percent. Effective December 1, 2006, the general sales and use tax drops from 4.5% to 4.25%. The state sales tax drops to 4% effective July 1, 2007. Sess. Laws 2006-66; N.C. Gen. Stat. § 105-164.4(a).

- **Streamlined Sales Tax Project conformity for the telecommunications industry**

As part of North Carolina's ongoing adoption of streamlined sales tax provisions, the General Assembly has conformed its telecommunications tax statutes to the streamlined sales tax framework, including an array of definitions adopted for various telecommunications categories. The updates take effect on January 1, 2007. Sess. Laws 2006-33.

- **Changes to sales tax payment schedule for semimonthly taxpayers**

Formerly, taxpayers only needed to pay sales taxes when their returns were due, whether quarterly, monthly, or semimonthly. The General Assembly has changed this schedule for taxpayers that consistently pay more than \$10,000 per month in sales taxes. Effective October 1, 2007, such taxpayers must prepay each month's tax liability. This prepayment must be at least 65% of either the current month's sales tax bill, the tax bill for the month at issue from the previous year, or the average

monthly amount of sales tax due in the previous year. N.C. Gen. Stat. § 105-164.16; Sess. Laws 2006-33.

In addition, this change eliminates the need to pay sales tax liabilities twice a month. Instead, taxpayers will now only have to pay the balance of the previous month's sales tax liability, plus an estimation (as defined by statute) of 65% of the next month's sales tax liability, on or before the 20th day of the month.

- **Sales of modular homes now taxed as retail sales**

North Carolina now requires that sellers of modular homes pay a 2.5% sales tax. Sales of modular homes to homebuilders are now considered retail sales. In other words, a sale of a modular home is a retail sale whether made to a modular homebuilder or directly to the end user. Sellers of modular homes receive a credit against sales tax for any sales or use tax paid to another state on tangible personal property that was incorporated into the modular home. The change was effective on July 1, 2006, and applies to sales on or after that date. Sess. Laws 2006-33; N.C. Gen. Stat. § 105-164.4(a)(8).

- **Sales of electricity to Internet data centers**

The General Assembly has exempted sales of electricity to Internet data centers from the sales tax. Internet data centers are those that function as Internet service providers and Internet web search portals as defined by N.C. Gen. Stat. § 105-164.3. In order to be eligible for the tax exemption for sales of electricity, Internet data centers must be certified by the Secretary of Commerce as having invested at least \$250,000,000 the facility within five years of its creation. *Id.* Eligible Internet data centers are exempted from sales tax on sales of electricity for use at the facility. N.C. Gen. Stat. § 105-164.13(55). The provision goes into effect on October 1, 2006. Sess. Laws 2006-66.

- **Reduced sales tax for electricity sold to manufacturers**

The General Assembly has lowered the sales tax on electricity sold to manufacturing industries and manufacturing plants from 2.83% to 2.6%. N.C. Gen. Stat. § 105-164.4(a). The lower rate will go into effect as of July 1, 2007. Sess. Laws 2006-66.

- **Tax credits for biodiesel producers**

Producers of at least 100,000 gallons of biodiesel fuel per taxable year have been given a credit equal to the excise tax on the biodiesel fuel that the producer paid on the fuel. This credit may not exceed \$500,000. N.C. Gen. Stat. § 105-129.16F. The tax credit lasts from taxable years starting on or after January 1, 2008, until those starting on or after January 1, 2010. Sess. Laws 2006-66.

- **Temporary cap on the motor fuels tax**

In response to the high gasoline prices over the summer, the General Assembly capped the gasoline tax until June 30, 2007. The tax is computed based in part on the average wholesale price of gasoline

for the prior six months. The entire amount of the tax may not exceed 12.4¢ per gallon until the cap expires next June 30.

Judicial developments: Tax on satellite service not unconstitutional

In *DirectTV, Inc. and Echostar Satellite, L.L.C. v. State*, ___ N.C. App. ___, 632 S.E.2d 543 (Aug. 1, 2006), satellite television service providers sued the State of North Carolina for a refund of nearly \$30 million in sales taxes on the basis that N.C. Gen. Stat. § 105-164.4(a)(6), which taxes “[d]irect-to-home satellite service,” but not cable television service, violated the Commerce Clause of the U.S. Constitution. *Id.* at 546.

Writing for the Court, Judge Wynn first dismissed plaintiffs’ contention that the statute was a facial burden on interstate commerce. Because the tax statute did not make a distinction between in-state and out-of-state satellite television providers, it was not facially discriminatory against out-of-state merchants. *Id.* at 548.

The Court next turned to plaintiffs’ argument that the statute discriminated against out-of-state businesses in its application, given that cable television providers are located in-state, whereas satellite providers are inherently out-of-state given that the satellites are in outer space orbit. The satellite television tax did not discriminate against interstate commerce, according to the Court, because the tax only applies to a method of delivering television programming services, not their location. An in-state satellite television service provider would be equally liable for the tax, and an out-of-state cable television service provider would be treated the same as an in-state cable television service provider. *Id.* at 550. Moreover, the Court observed that cable television companies were already liable for a franchise tax specifically levied on them, such that the satellite television sales tax equalized the tax burdens between the two methods of television programming distribution. *Id.*

Administrative developments

The Department of Revenue has published guidelines on when sales of manufacturing fuel and mill machinery are exempt from sales and use tax and are subject to the imposition of a privilege tax under N.C. Gen. Stat. § 105-187.50 *et seq.* 17 N.C.A.C. 07D .0101; 17 N.C.A.C. 07D .0102. For the purposes of tax administration, the Department classifies activities engaged in by these taxpayers into three categories: (1) industrial manufacturing that results in a finished product, (2) product distribution processes, and (3) office administrative work-related equipment. The guidelines specify the types of machinery that are subject to the special provisions of Article 5F of the tax code. 17 N.C.A.C. 07D .0201, .0202; *see* N.C. Gen. Stat. § 105-187.50 *et seq.* Taxpayers with questions regarding these classifications are directed to submit them to the Department for determination.

The Department has also published rules on when manufacturers are liable for sales and use tax based on the nature of the buyer—whether the sale is for resale or for end use. 17 N.C.A.C. 07D .0103. These rules also specify when sales need not be reported to the Department and when records are required to support the taxpayer’s designations of sales as being exempt from tax.

Property Tax

Property tax appeals

The General Assembly has rewritten the statutes governing assessments for which an appeal is pending, clarifying that property tax assessments that have been appealed to the Property Tax Commission from the county board of equalization and review are not due until final disposition of the case. This codification was effective as of the date of ratification, on June 29, 2006. Sess. Laws 2006-30; N.C. Gen. Stat. § 105-378(d).

Other Tax Developments

Tax increases that apply to the taxable year in which passed not unconstitutional

Coley v. State, 360 N.C. 493, 631 S.E.2d 121 (2006), was the byproduct of a tax hike, partially abrogated by the above tax cut, when budgetary shortfalls were substantial during the early 2000s. On September 26, 2001, Governor Mike Easley signed into law a tax increase of .5% for the highest personal income bracket, from 7.75% to 8.25%. The tax increase was effective for the tax year 2001, and the plaintiffs in the case sued on the basis that the tax hike constituted a retrospective tax in violation of N.C. Constitution art. I, § 16, which states, “No law taxing retrospectively sales, purchases, or other acts previously done shall be enacted.”

A divided Court of Appeals affirmed the dismissal of the lawsuit by the trial court. Because of the dissent in the case, plaintiffs had a right of appeal to the N.C. Supreme Court. On June 30, 2006, the Supreme Court affirmed the dismissal of the case on the basis that the tax increase did not violate the constitutional prohibition on retrospective taxes. Writing for the Court, Justice Edmunds held that the income tax was subject to the retrospective tax prohibition, given that the earning of income qualified as an “other act[.]” *Id.* at 499, 631 S.E.2d at 126. However, the Court held that a same-year tax increase did not in fact retrospectively tax income, given that the taxpayer’s income is not fixed until the end of the taxable year and was not assessed until due. *Id.* at 503-04, 631 S.E.2d at 129.

Dissenting from the determination that the tax increase did not constitute a retrospective tax, Justice Brady wrote that the case was controlled by *Young v. Town of Henderson*, 76 N.C. 420 (1877), and that income is earned when the act of producing the income is completed, even though it is not collected until the end of the year. *Id.* at 506, 631 S.E.2d at 130.

Changes to the Job Development Investment Grant Program

North Carolina has raised the annual limit on tax incentives for new and expanding businesses under the Job Development Investment Grant Program (“JDIG”) from \$15 million to \$30 million. JDIG awards up to twenty-five grants per year to business expansion projects that an Economic Investment Committee, made up of the Secretary of Commerce, the Secretary of Revenue, the Director of the Office of State Budget and Management, and two people appointed by the General Assembly. Projects that have been awarded grants include a recent \$100 million facility planned for Wake County by Fidelity

Investments, a \$7 million call center for Verizon Wireless in New Hanover County, and a \$44 million airplane turbine engine plant by Smith Aerospace Components in Ashe County.

Changes to the William S. Lee Act tax credit program

The William S. Lee Act governs North Carolina's extensive program for providing sales tax and corporate income tax credits to businesses that invest in qualifying job-creation and investment. Qualifying businesses must meet wage, health insurance, environmental, and occupational health standards in order to receive credits under the program.

The existing Lee Act program divides North Carolina into five tiers segregated by economic factors. The new Lee Act divides the one hundred counties into three tiers. Simplification of the tier structure is designed to lower the volatility and enhance the predictability of the current tier structure, in which counties routinely shift between tiers from year to year. In addition, the new Act abandons the large urban development zones that were seen as overly broad in geographic scope to accomplish the urban renewal goals of the program. In their place, the General Assembly has created more compact "Urban Progress Zones" focused on economically distressed urban areas.

Under the new program, tax credits are available for three categories of investments: job-creating investments, real property investments in the lowest tier counties, and investments in business property.

Only certain industries and types of facilities are eligible for Lee Act tax credit incentives: aircraft maintenance and repair facilities, air courier service hubs, qualifying company headquarters, customer service call centers, electronic shopping and mail order houses, information technology facilities, manufacturing plants, motorsports and racing team facilities, research and development investments, warehouses, and wholesale trade facilities.

The Lee Act's wage tests have also been modified. Previously, qualifying job-creating investments had to pay wages in excess of 110% of either the state or the county average wage. The new Lee Act lowers the threshold for the county average option to 90% of the county average wage and maintains the total exemption from the wage testing requirements for the lowest tier counties.

Small business health insurance tax credit

The General Assembly has given qualifying small businesses an income tax credit against health care costs for their employees if the businesses provide health insurance benefits for all eligible employees. N.C. Gen. Stat. § 105-129.16E; Sess. Laws 2006-66. The tax credit is \$250 per employee who makes no more than \$40,000 per year, provided that the employer pays at least half of the costs that exceed the amount paid by the health insurance plan. The credit cannot exceed the amount that the employer pays for the employee's health care during the taxable year. This tax credit is effective January 1, 2007, and is set to expire on January 1, 2009.

[State & Local Tax Practice Group](#)

Maupin Taylor's Tax Practice has a national reputation for its successful representation of businesses operating in North Carolina. Firm tax attorneys have provided business and individual clients with a complete portfolio of tax planning, administrative and litigation services relating to local, state, federal and international tax matters. The Firm's state and local tax practice is staffed by attorneys Nancy S. Rendleman, Charles B. Neely, Jr., Steven B. Long, and Robert W. Shaw, and Angie Harris, Director of the Government Relations Practice. The group practices extensively in the state and local tax area and handles matters involving all types of state and local taxes, including corporate income and franchise tax, sales and use tax, property tax litigation involving real and personal property and the tax exempt status of real and personal property, intangibles tax, excise and license taxes and personal income tax. The practice also counsels clients on county and state tax incentives, assists them in negotiations to obtain tax incentives, and defends against efforts by the Department of Revenue to attack tax credits.

Maupin Taylor's representation of clients involves litigation and negotiation of contested matters, corporate tax planning, transactional matters, lobbying and negotiation of tax incentive packages. It has mounted successful challenges to a discriminatory state franchise tax, to discriminatory property taxes and to numerous other tax assessments. It has successfully tried the largest personal property tax appeal in North Carolina, resulting in new valuation tables for computer and high tech manufacturing equipment. The firm has also been successful in advocating changes to tax statutes in the North Carolina General Assembly. It has represented corporations in the defense of class action lawsuits involving state tax issues in both Federal and state courts. Attorneys have extensive experience contesting state corporate income tax assessments and disputes over apportionment methodologies. Maupin Taylor's state and local tax attorneys also collaborate regularly with the firm's corporate attorneys on behalf of clients on tax consequences of corporate structures and transactions.



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