

2006 ANNUAL MEETING
TAXATION COMMITTEE
NORTH CAROLINA ASSOCIATION OF CERTIFIED PUBLIC ACCOUNTANTS
AND
NORTH CAROLINA DEPARTMENT OF REVENUE
Questions/Responses

1) Individual Income Tax

- a) Please provide a list of the errors that the Department sees in individual income tax returns submitted by professional preparers.

Response:

- Vendor forms: dollar amounts in column one blended with line numbers in column two.
- Tax credit forms: not using the software version of the D400 TC. CPA would fill out web or web fill form to attach.
- Missing W-2s - they were either missing completely or not all W-2s were filed with return.
- Returns filed with wrong year W-2s.
- K-1 information was reported on lines 19a and 19b incorrectly. Should be reported elsewhere on the return.
- Filing forms with "Form not approved" watermark.
- Bad print quality.
- Photocopies of forms were used. Please use originals.
- All returns must have social security numbers or ITIN numbers for all taxpayers listed.
- Printing instructions were not followed. Our imaging equipment requires that barcodes, scan lines and other key information be placed in certain locations on the forms. Therefore, instructions for printing from the web and software packages are very specific on how to print the forms properly. Example: dollar amounts should not bleed over to the next column. To ensure that your software package is formatting the form correctly, please see our website at www.dorn.com/developers/final.html and select forms from the final scan band forms.
- We have received quite a few forms with "Form Not Approved" this past year.
- Wrong Bailey Settlement amounts (not claiming the full amounts).
- Wrong estimated tax payment amounts.

- b) Please discuss the confusion involving the apparent error in the CCH Prosystem FX software where the some of the 2006 forms NC-40 were printed with scan band information indicating a 2005 filing? What can practitioners do to prepare for the 2006 filings where the correct application of estimated tax payments would be in doubt?

Response:

1. The issue concerns the scan line on the coupon that indicates tax year 2005 on forms printed for filing your 2006 estimated income tax payments. Many of these 2006 estimated income tax payments for the first and second quarter have been processed as 2005 payments and may have been refunded from the 2005 return rather than credited to the 2006 tax year.

2. The North Carolina Department of Revenue recommends that your estimated income tax vouchers be reprinted to ensure that the third and fourth quarter payments, due September 15, 2006 and January 15, 2007, will be posted to the correct account. Taxpayers whose payments were refunded may resubmit the estimated payments without penalty. The replacement check or checks must be sent with reprinted estimated income tax coupons attached to a copy of the taxpayer's notification letter from NC Department of Revenue for special handling. Please send these payments to the address below:

North Carolina Department of Revenue
Post Office Box 2628
Raleigh, North Carolina 27602-2628

- i) How do you recommend that practitioners confirm the payments that have been applied to a taxpayer's account in advance of filing 2006 tax returns for taxpayers that may be at risk in this computer error?

Response: Tax Practitioners can call the DOR Tax Practitioner Priority Service at 919-754-2500, between 8:00 a.m. and 5:00 p.m. EST, Monday through Friday, to speak with Department of Revenue tax professionals who can assist them with many of their technical and account specific questions about corporate income and franchise tax, individual income tax, sales and use tax, and withholding tax.

- c) Please comment on the following reports by practitioners. If the Department agrees with any of these observations, what can practitioners do in these cases?

- i) There may be a pattern of e-filing submissions that are rejected when there is both a penalty on D-400 line 22b and an overpayment on line 24.

Response:

- Reject Code 9010 states: When line 18 is less than line 21, then lines 22a through 23 must be blank or zero.
- Solution: We are looking at revising that reject code to state: When line 18 is less than line 21, then lines 22a and 22b must be blank or zero.

- ii) There appears to be a tendency to experience processing delays and problems when a state amended return is processed before a federal amended return, resulting in the fact that the state information might not match the information in the federal database in that time window.

Response: Any delay in processing an amended North Carolina return is unrelated to the processing of federal amended returns. Practitioners who experience a problem with amended returns are encouraged to call our Tax Practitioner Priority Service at (919) 754-2500.

- iii) Notices were sent to taxpayers in the last year where the taxpayer was a dependent child who does not claim their own exemption, but is entitled to a federal education tax credit under Regs. 1.25A-1(g).

Some tax software providers felt that this triggered a state other subtraction for the tuition deduction, and the notices indicated that the Department disagreed. Please discuss this issue.

Response: Pursuant to Federal Regulation 1.25A-1(f), a student dependent may claim the tax credit for the student's qualified tuition expenses if the student is not claimed as a dependent by another taxpayer. For example, higher income parents whose AGI would result in the phase out of the dependency exemption may waive claiming the dependency exemption to allow their student dependent to claim an educational credit, assuming the student has a sufficient tax liability to be offset by the educational credit. However, this does not entitle the student dependent to claim a personal exemption on his or her return.

Under Code section 222, the federal deduction for qualified tuition expenses is not allowed to a taxpayer who can be claimed as a dependent on another person's tax return. The deduction is not allowable even if the other person does not actually claim the dependency exemption.

For State purposes, a taxpayer may deduct the amount by which the taxpayer's deductions allowed under the Code were reduced, and the amount the deductions were not allowed, because the taxpayer elected a federal tax credit in lieu of a deduction. In this case, the student was entitled to the education credit but not entitled to the deduction for tuition expenses on the federal return. Therefore, the education tax credit was not claimed "in lieu of" the federal deduction for tuition expenses. Consequently, the adjustment by the Department to disallow the deduction for tuition expenses claimed on the State return was proper.

- d) Does the Department track taxpayer's adjustments for IRC 168(k) bonus depreciation additions through year 2004 and its corresponding subtractions that began with tax year 2005?

Response: Yes. The Department captures the adjustments on both corporate and individual income tax returns.

- e) The Department's amended return processing delays appears to have eased in the last year. Please comment on this.

Response: Amended returns were processed in our processing division with the same priority as current year returns. This was the second year we did this. Amended returns are actually worked manually once they have been received and processed. Resources have been committed to make the necessary adjustments throughout the tax filing season whereas in the past, amended returns were worked at the end of the tax filing rush. You may have noticed that we have also changed our instructions to reflect this timelier processing of amended returns.

- f) Please explain the Department's current policy that underpayment penalties are the equivalent of interest, which cannot be waived under a reasonable cause exception.

Response: Prior law required a penalty to be assessed for underpayment of estimated income tax by individuals and corporations. The penalty was subject to waiver pursuant to the Department's penalty policy. The penalty has always been considered in the nature of interest because it is determined by applying the applicable annual interest rate to the

amount of the underpayment for the period of the underpayment. In 2005, the General Assembly enacted Senate Bill 622, which in part, clarified that an amount assessed under G.S. 105-163.15 and G.S. 105-163.41 is interest, not penalty. Accordingly, all references in the statute to the word "penalty" were replaced with the word "interest." There is no provision in North Carolina law to waive interest.

- g) What is the Department's current policy with the handling of protested tax returns? Are they segregated in any way? In the Department's view, what is the current procedure for filing a valid protest?

Response: I would refer you back to the response the Department provided to North Carolina Association of Certified Public Accountants on January 28, 2005. "While we cannot predict what a court would do, the most conservative approach would be for each taxpayer to file a demand for refund under N.C. Gen. Stat. § 105-267. In our opinion, such demand should include, at a minimum, the taxpayers name and identifying number, the tax schedule, the tax year, the amount of refund sought, and the basis for the refund claim. In other words, the demand for refund should include enough information to enable the Secretary to determine whether the taxpayer is entitled to the refund." Since we consider the filing of a refund under protest to be a potential legal matter, I am afraid I am going to defer to providing a response. You may want to seek legal counsel.

2) Corporate Income Tax

- a) Please provide a list of the errors that the Department sees in corporate income tax returns submitted by professional preparers.

Response:

- Wrong year forms used.
- Poor print quality.
- Incomplete scan band. Missing required information.
- Spiral binding, large holes punched into returns, holes in either corner of the returns.
- Missing pages.

- b) What is the current status of the Department's planned use of electronic filing of income tax returns for "C" corporations and "S" corporations?

Response: (See Section 10 for State response.)

- c) Regarding the franchise tax schedule C adjustments for deferred tax balances –

- i) Please provide an historical overview of the Department's treatment of deferred tax liability and deferred tax asset accounts for purposes of the Schedule C Capital Stock, Surplus and Undivided Profits franchise tax base.

Response: G.S. 105-122(b) provides in part that "...no reservation or allocation from surplus or undivided profits shall be allowed other than for definite and accrued liabilities..." Thus, according to statute, all contingent liabilities, including deferred income tax liabilities, must be included in the calculation of the capital stock, surplus and undivided profits base.

Prior to 1992, FASB allowed taxpayers to maintain one deferred tax account, which netted the taxpayer's deferred tax liabilities and deferred tax assets. The "net" deferred tax liability was included in the capital stock, surplus and undivided profits base. In 1992, FASB Statement No. 109 required taxpayers to separately state deferred tax liabilities and deferred tax assets. The law required the deferred tax liability account to be included in the capital stock, surplus and undivided profits base but the law did not permit the deferred tax asset account to be used to reduce the base.

On August 1, 1996 effective for tax years ending on or after July 31, 1996, the Department issued Technical Advice Memorandum CTAM 97-4 announcing an administrative policy that permitted taxpayers to reduce, but not below zero, a deferred liability by the deferred tax asset amount that resulted when the deferred liability was required under the financial accounting standards to be determined and recognized for financial reporting purposes. The intent of the TAM was to restore taxpayers to the same position for franchise tax purposes that they were in prior to the FASB. However, the TAM as written appeared to contradict the plain meaning of the statute because it permitted the deferred tax liability accounts to be reduced by deferred tax asset accounts. Since the issuance of the TAM, taxpayers have also argued that they should be able to reduce deferred tax liabilities below zero if the deferred tax assets exceeded the deferred tax liabilities and that they should be able to reduce all types of deferred liabilities by deferred tax assets.

Since the Department's current administration believed that the former administration allowed a deduction not permitted by statute, the Department requested that the General Assembly amend G.S. 105-122(b) to clarify whether deferred tax assets could be deducted from the capital stock, surplus, and undivided profits tax base and, if so, under what, if any, limitations.

On May 10, 2006, Senate Bill 1283 was filed to make stylistic changes to G.S. 105-122(b) and to statutorily adopt the Department of Revenue's intended administrative practice with respect to reducing the taxpayer's deferred tax liability account by its deferred tax asset account announced in Technical Advice Memorandum CTAM 97-4. On June 30, 2006, the bill was ratified by the North Carolina General Assembly and was signed by the Governor on July 10, 2006.

- ii) What is the current treatment of deferred tax liability and asset accounts for North Carolina franchise tax purposes?

Response: Pursuant to G.S. 105-122(b), a taxpayer must include deferred tax liabilities in the calculation of the capital stock, surplus, and undivided profits base because they are not definite and accrued legal liabilities. A taxpayer is allowed to reduce deferred tax liabilities included in the capital stock base by netting deferred tax assets against the deferred tax liability. The reduction may not decrease the amount of deferred tax liability below zero. No other deferred liabilities may be reduced by the deferred tax asset account.

- iii) Please provide an explanation of the effective date of recent legislation on prior year franchise tax returns and indicate whether there will be "open" tax years for requesting a franchise tax refund.

Response: Session Law 06-95 is effective for taxable years beginning on or after January 1, 2007. Since franchise tax is prepaid, the recent legislation impacts the franchise tax reported on the 2006 tax return since this return is used by taxpayers to compute its franchise tax liability for tax years beginning on or after January 1, 2007.

Regarding "open" tax years, since Session Law 06-95 statutorily adopted the Department's long-standing administrative practice with respect to reducing a taxpayer's deferred tax liability account by its corresponding deferred tax asset account (*see Technical Advice Memorandum CTAM 97-4*), the Department does not believe the legislation results in refunds. However, any taxpayers that have not previously reduced their deferred tax liability account by their deferred tax asset account may amend any franchise tax return that is still open under the statute of limitations.

3) Partnership Income Tax

a) Please provide a list of the errors that the Department sees in partnership income tax returns submitted by professional preparers.

Response:

- FIDs were either missing or did not have enough characters.
- Wrong tax year forms were used.
- Sent in incomplete NC forms along with Federal return with note to refer to Federal return.
- Indicated that returns were both original and amended returns.
- Incomplete mailing addresses on estate returns.
- Not submitting tax due for the nonresident individual partners;
- Not attaching affirmations for corporations, partnerships, trust or estate;
- Attaching affirmations for individuals (not allowed);
- Showing out-of-state income as a deduction;
- Showing tax paid by other partnership or S-corporation on the wrong line (should be on line 13 not line 12).

b) What is the current status of the Department's use of electronic filing of income tax returns for partnerships?

Response: (See Section 10 for State response.)

4) Estate and Gift Tax

a) Please provide a list of the errors that the Department sees in estate and gift tax returns submitted by professional preparers.

Response:

- Not attaching pages 1, 2 and 3 of the Federal Form 706 if the decedent was domiciled in North Carolina and all property was located in North Carolina.
- Not attaching a complete copy of the Federal Form 706 if the decedent owned property outside North Carolina or was not domiciled in North Carolina.
- Confusion between individual extension (D-410) and the gift extension (D-410G).
- Listing the tax value of the gift of property rather than the fair market value.
- Confusion on class of “in laws” on gift tax returns. In-laws are Class C donees instead of Class A donees.

b) Are there specific documents that the Department is recommending be attached to the NC Estate returns?

Response:

- A schedule of federal gifts showing the year, amount, and donee;
- Copy of other state’s return filed.

i) NC Gift tax returns?

Response: Copies of appraisals to support the fair market value of the gift.

c) What is the process to find out whether prior gift tax returns have been filed? How do we obtain copies of previous filed gift tax returns?

Response:

- Taxpayers may contact the Department of Revenue at 1-877-919-1319.
- Written requests for information may be submitted and should identify specific information requested along with a power of attorney.

d) How far back are copies of gift tax returns maintained?

Response: Gift tax returns are maintained indefinitely until the Department of Revenue is notified that the taxpayer is deceased. At that time, any gift tax returns filed are retained with the estate return.

e) Can you provide us with the number of estate and gift tax returns filed last year and tax collected from both forms?

Response:

- Jan-Dec 2005 Estate Returns filed 1368
 Amount collected \$121,287,323
- Jan-Dec 2005 Gift Tax Returns filed 5266
 Amount collected \$18,502,939

f) On a gift tax return, when a spouse consents to allow taxpayer to claim their annual exclusion, is there a recommended format or schedule the Department would recommend to be attached to return to support the amount

of annual gift exclusion being applied? Is there a recommended presentation on page 3, column 6 for the annual exclusion when a spouse consents to give up their exemption?

Response:

- The preparer should check the information on the front page of the return indicating consent is being given, noting that consent may be given only on a timely filed return.
- Completion of the form on page 3, column 6 as instructed is sufficient.

5) Communications

- a) What is the status of secure email conversations with Department personnel?

Response: Currently, the Department cannot provide a secure e-mail environment for communication with taxpayers. Therefore, while we can discuss general issues, we cannot offer taxpayers specific guidance via e-mail. As you may know, Secretary Tolson is committed to an organizational transformation initiative called Vision 2010. As a part of this initiative, we are looking at a variety of ways to move the organization forward in our quest to be more customer-friendly and responsive to the needs of taxpayers through use of a variety of new technologies. Potentially, changes surrounding Vision 2010 may include a change in our e-mail process.

- b) When a tax return is changed due to a difference in payments claimed on the return and the Department's records, is it possible to have a transcript of the payments and date received included with the notice to the taxpayer?

Response: Again, because of the limitations of our current technology, we are not able to offer this service. Potentially, we will eventually be able to provide this as a part of our Vision 2010 initiative.

- c) Please comment on the policy regarding the Department's acceptance of the IRS Form 2848 as a valid power of attorney. Some practitioners still report that the federal form is not being acknowledged by the Department.

Response: The Department's policy is to accept the federal form IF the taxpayer specifically indicates on the form that it can be applied to state tax matters.

- d) Please discuss how the new penalty abatement procedures interact with the "reasonable cause" exception. For example, a practitioner has reported that after verbally giving reasonable cause while speaking on the phone with a Department representative about a taxpayer penalty, the issue was quickly resolved when the representative stated that she would remove the penalty from the taxpayer's account right then. She never mentioned whether the penalty was removed for reasonable cause or whether she used the taxpayer's waiver of penalty that is allowed once every three years ("freebie"). After the phone call ended and upon further reflection, the practitioner is now worried that the taxpayer has used his "freebie" when he indeed had reasonable cause for the penalty to be abated. If the taxpayer is subsequently charged with another penalty, and it is found out that the NCDOR representative squandered the taxpayer's "freebie," will we be allowed to go back and have the reasonable cause exception applied to the previous penalty so that the taxpayer can use the "freebie" for the subsequent penalty?

Response:

- a. As you know, there is a difference between the abatement and waiver of a penalty. A penalty is abated when it is removed because it was imposed in error. This usually occurs after a departmental error or submission by the taxpayer of a replacement check. A penalty is waived when the penalty was properly applied, but is removed or reduced through the exercise of the Secretary's discretionary power to waive or

reduce penalties. There are limitations to the number of times and under what circumstances waivers can be issued.

- b. It is very difficult to answer this question without knowing the specifics of the case. Suffice it to say, that in this particular situation, it would be prudent for the taxpayer to check with the Department about how the exception was applied.
- c. The Department of Revenue will have a new penalty policy, effective December 1, 2006. Please see the Department's website after that date to view the revised policy.

6) Audits

- a) Does the Department have any procedure (similar to the Freedom of Information Act Requests) for obtaining copies of audit files on a particular case for either closed or in process cases? If so, what is the procedure?

Response: The North Carolina Public Records Act generally allows people to obtain copies of public records and public information. The Public Records Act has a specific exception for State tax information, however, which may only be disclosed as provided by G.S. 105-259. G.S. 132-1.1.

- b) When a practitioner is solicited by a taxpayer to prepare delinquent individual income tax returns and forms W-2 are involved, the taxpayer or practitioner can request a federal transcript to see the W-2 information. However, the Internal Revenue Service does not track state wage withholdings. Practitioners note that the Department has not been able to assist with these amounts. If the Department is not able to furnish preparers with the state withholding from prior year W-2s filed with the state, then how does the state know that the correct amount is shown on the prior year returns when filed? If the state has this information, then why is it unwilling to furnish it to taxpayers and return preparers? What can practitioners do to assist the Department in this regard?

Response: DOR recommends that delinquent filers of individual income tax returns contact their employers to obtain lost W-2 or NC-2 tax information. Any individual income withholding data available within DOR will be shared with the individual or representative. Today, withholding data is stored in disparate data sets, which are not readily accessible.

As DOR transitions to a more robust e-business operating environment, we expect to have improved access to all withholding information.

- c) Practitioners report that the Department does not provide taxpayers with a description of the complete Appeal process when the taxpayer does not agree with the final assessment from a tax audit. Please comment.

Response: The standard operating procedures for Examination personnel indicate that the Taxpayer Bill of Rights will be provided to taxpayers for all office and field audit cases. The Bill of Rights covers the appeal process. The Taxpayer Bill of Rights is printed on the reverse side of Notices sent by NCDOR. A copy is also available on our website.

- d) Is the Department currently singling out certain industries for tax audits? If so, how is the selection of these industries determined?

Response: The Department does not normally single out specific industries for examination. However, if audits reveal material areas of non-compliance, additional audits may be performed on taxpayers engaged in the same type of business.

- e) It appears that sales tax auditors are extending their audits to include income and payroll tax returns in connection with their sales tax audit. Is this correct?

Response: The Examination Division has a small unit of auditors whose work is confined to only sales and use tax audits. The unit, of 6 auditors, focuses on refund claims and consumer use tax.

The 190 field auditors in the Division are responsible for state tax audits. These audits most often cover sales and use, withholding, corporate/franchise, and individual income taxes as may be applicable.

- f) When sales tax audits are referred to the criminal division for investigation, it appears that there is a six months or longer delay before either the taxpayer or practitioner is notified about the change in status of the audit. Please comment. Why is the delay so long? Should the taxpayer be informed of the change in status immediately to allow him to seek legal counsel and protect their rights?

Response: Cases accepted into CID's inventory are assigned for investigation based on a number of factors, including agent caseload, experience, location, and case priority. The inventory constantly evolves and requires matching the correct skill sets with the fact base. Our goal is to work the most egregious cases first, which sometimes requires holding older cases for investigation until they can be addressed with the correct resource.

We always advise taxpayers of the shift in focus when we meet with them. It is the taxpayer's responsibility to determine if or when they need legal counsel. We immediately suspend any interview where a taxpayer requests counsel.

- g) Random audits of individual taxpayers seem to be increasing after years of little activity. Please comment.

Response: Audits of individual taxpayers continue to increase due to the substantial non-compliance discovered with our individual income tax laws. However, these audits are not of a random nature. The Examination Division utilizes various queries and data matches for identification of potential non-compliance.

7) Tax Credits

- a) Please provide a list of the errors that the Department sees in tax credit filings submitted by professional preparers.

Response: Currently, we do not have any problems with tax credit filings filed submitted by professional preparers. Most of the few tax credit errors we see come from taxpayers who do not submit enough pages of the form.

- b) Please provide a technical explanation of the changes to the Bill Lee tax credits for 2006 and 2007 returns.

Response: Effective for taxable years beginning on or after January 1, 2007, the General Assembly created the Article 3J credits by enacting House Bill 2170. These credits are designed to replace the Article 3A credits, also known as the William Lee Act. The William Lee Act is set to expire for taxable years beginning on or after January 1, 2007, with some exceptions. A taxpayer cannot take Article 3J credits and Article 3A credits with respect to the same establishment. (Note: The Article 3J tax credits were originally enacted as Article 3I but was recodified to avoid confusion with Article 31 of Chapter 105.)

The basic eligibility requirements for Article 3J tax credits are the same as for Article 3A. They include:

1. Be an eligible business type
2. Meet the wage standard
3. Provide health insurance for employees
4. Have a good environmental record
5. Have a good Occupational Safety and Health Act (OSHA) record
6. Have no overdue tax debts with the State.

The primary differences between the Article 3I tax credits and the Article 3A tax credits include the following:

General Administration

- There are three tax credits instead of seven (Note: there had been eight tax credits in Article 3A. The research and development credit in Article 3A had previously sunset and was replaced by a new research and development tax credit in Article 3F).
- There are three additional eligible businesses. They are motorsports facilities, motorsports racing teams, and research and development services.
- Company headquarters has to add 75 headquarters type jobs instead of 40 in order to be eligible.
- Three tiers instead of five tiers.
- Wage Standard has to be met in tiers two and three.
- Development zones replaced by urban progress zones and agrarian growth zones.
- Taxpayer may divide credit between the taxes against which it is allowed.

Jobs Credit

- Threshold requirements added; 5 in tier one, 10 in tier 2, 15 in tier 3. Once threshold is satisfied, taxpayer gets credit for all additional jobs.
- Credit rates are \$12,500 in tier one, \$5,000 in tier two, \$750 in tier 3.
- Credit increased by \$1,000 if located in urban progress or agrarian growth zone.
- Credit increased by \$2,000 if filled by zone resident or long-term unemployed worker.

Business Property Credit

- Replaces the machinery and equipment credit. Credit is broader as it includes all tangible personal property that is capitalized under the Code.
- Credit rates are 7% for tier one, 5% for tier two, 3.5% for tier three.
- Thresholds are 0 for tier one, \$1 million for tier two, \$2 million for tier three.
- Credit taken in four installments instead of seven.

Credit for Investment in Real Property

- Replaces credit for substantial investment in other property.
- Credit available only for real property located in tier one area.

For more information about the Article 3J tax credits, please refer to the Department's Guidelines for Article 3J Credits, found on the Department's website by going to the Tax Professionals portal and then selecting Tax Information/Corporate Income and Franchise/Corporate Income Tax/Tax Credits for Growing Businesses.

8) Sales and Use Tax

- a) Please provide a list of the errors that the Department sees in sales and use tax returns submitted by professional preparers.

Response: If a taxpayer is required to file an E 536 or E 543 (State and county breakdown), please use software version or web version of these forms. We have problems with taxpayers sending their own forms instead of Department approved forms.

- b) Please update us as to plans for an on-line application form with an automatic assignment of a registration number similar to the system the IRS currently has for taxpayer identification numbers?

Response: The plan for adding on-line registration for sales and use tax and other schedules included on the current application is part of the Department's Project Definition and Planning (PDP) process. It is anticipated that the registration piece will be a priority of the PDP. Timelines for implementation of the elements of the plan have not been set.

- c) Are there any plans to allow electronic filing of Form E-500J, "Machinery, Equipment and Fuel Tax Return," and other sales and use tax forms?

Response: The PDP anticipates that almost all returns will eventually be able to be filed electronically. As stated in #2, timelines have not been established.

- d) What percentage of taxpayers reported consumer use tax on their 2005 Form D400, and how much tax was collected?

Response: Through October 2006, 2.98% of returns included reporting of consumer use tax and \$5.01 million in tax was collected.

9) Forms and Instructions

- a) Comment on the progress made with the software developers at the Department's recent meeting with them. What improvements can we expect in form approval as a result?

Response:

- Providing additional resources.
- Allowing forms to be sent via email in PDF format.
- Sending periodic emails to developers on release of drafts, finals, spec, and grid layouts.
- Redesigning of the Software Developer's website.
- Emailing PDF forms for corrections (with markups and comments).

- b) Please discuss the responsibility of the preparer and taxpayer related to the check boxes for political contributions. Practitioners express confusion as to who is responsible to mark the boxes.

Response: North Carolina law prohibits a preparer from making a designation, either for or against, to the North Carolina Political Parties Financing Fund or the North Carolina Public Campaign Fund without the taxpayer's consent. Therefore, it is incumbent on the preparer to provide information about each fund to the client and ask the client if a designation to either fund should or should not be made. If consent is not provided, a preparer should not make a designation, either for or against, on behalf of the client.

10) Other General Questions

- a) Please provide an overview of the NCDOR administrative review and appeals process. Indicate any distinctions in the appeals process for an individual or a corporate taxpayer.

Response: Any taxpayer that has received a proposed assessment may object to the proposed assessment. To do so, the taxpayer must, within 30 days of the date of the notice, file a written request for either a hearing or a written statement of the information and evidence upon which the proposed assessment is based. If the taxpayer timely requests a written statement, the Department will provide the written statement to the taxpayer within 45 days. If the taxpayer wishes to request a hearing after receiving the written statement, the taxpayer must file a written request for a hearing within 30 days after the written statement has been mailed by the Department.

Upon receipt of a timely request for a hearing, the Department suppresses the proposed assessment in ITAS to prevent any further notices or collection attempts and then contacts the taxpayer to acknowledge receipt of the hearing request. The law requires the Department to, within 60 days of the hearing request, set a date for the hearing. The date for the hearing must be within 90 days of the hearing request and the taxpayer must receive at least 10 days notice of the hearing.

Although the law sets out time limits for the hearing, the Department has had significant success in resolving taxpayer's objections without having to hold a hearing. The Department, therefore, uses the letter acknowledging receipt of the request for a hearing as an opportunity to further explain the adjustments and offer the taxpayer an opportunity to submit additional information or request an informal conference to discuss the case to see if resolution can be reached. If the taxpayer declines our invitation to submit additional information or attend an informal conference, we will proceed to schedule the hearing. If the taxpayer provides additional information or attends an informal conference, we will work with the taxpayer as long as it takes to resolve the file. At any point in the process, either the taxpayer or the Department can determine that the matter is not going to be resolved and we will then proceed to schedule a hearing. We apply the "hearing within 90 days rule" to the date the efforts to resolve the file are determined to be unsuccessful.

The process is basically the same for individual income, corporate income and franchise tax, and sales and use tax cases. Also, please note that the statutory language regarding hearings on refund adjustments in G.S. 105-266.1 reads differently than the language in G.S. 105-241.1 but the Department follows the same procedures outlined above.

- b) In the event that a taxpayer wishes to litigate an action by the NCDOR, does the taxpayer have the ability to file a civil suit in the Superior Court of their home county or are they required to file with the Superior Court of Wake County?

Response: The taxpayer can appeal to the Superior Court in Wake County or the county in which the taxpayer resides with one exception. If the appeal is on a reduced or denied refund under G.S. 105-266.1, the appeal has to be filed in Wake County Superior Court if the alleged overpayment is \$200 or less.

- c) Please indicate if there are differences in the appeals process for a Tax Review Board decisions versus a jeopardy assessment.

Response:

Tax Review Board: A taxpayer may appeal a decision of the Tax Review Board by filing a petition with the Superior Court in Wake County or the county in which the taxpayer resides within 30 days of the date the taxpayer receives the Board's decision. To appeal, the taxpayer must first either pay the tax, penalty, and interest asserted to be due or file with the Department a bond for the amount asserted to be due. There is no set time within which the Court must hear the case or render a decision.

Jeopardy Assessments: The Department may issue a jeopardy assessment so it can immediately collect tax it believes to be due in cases where the Department believes collection of the tax would be in jeopardy if the normal order of issuing a proposed assessment and waiting 30 days to see if the taxpayer protests the assessment before final billing it is followed. Except for criminal cases or unauthorized substance cases, the Department must issue a written statement of the information used to make the assessment within five days of issuing the jeopardy assessment. Within 30 days of receiving the written statement, the taxpayer may request the Secretary to review the action to determine if making the jeopardy assessment was reasonable and whether the amount assessed was reasonable. The Secretary must issue his decision within 30 days.

The taxpayer may appeal the Secretary's determination by bringing an action in the Superior Court in Wake County or the county in which the taxpayer resides within 90 days after the earlier of the date the taxpayer received or the date the taxpayer should have received the Secretary's determination described above. The court shall determine within 20 days after the action is filed whether the assessment is reasonable and the amount assessed is appropriate. The 20-day decision period may be extended for up to 40 days if the taxpayer shows reasonable grounds for the extension.

- d) Please provide a history of the North Carolina EFT program and an overview of the planned expansion of the EFT program. The following areas are of concern to the NCACPA members:

Response: The North Carolina Electronic Filing Program (EFT program) for individuals began in 1991 as a pilot project with the Internal Revenue Service. During the first year of implementation, the Department only allowed Revenue employees to participate in the program. In 1992, the program was expanded to permit North Carolina full-year residents who were expecting refunds to file electronically. Since that time, the e-file program has expanded to allow full-time, part time, and/or nonresident taxpayers who request refunds, have zero balances, or who owe individual income tax to file electronically.

Beginning in January 2006, the Internal Revenue Service began a pilot program with several states to offer a joint Federal/State corporate electronic filing program. This program allows corporate taxpayers in participating states to jointly file specific federal and state corporate tax forms electronically via designated IRS Service Centers. Currently, the Internal Revenue Service accepts only federal forms 1120 (C Corporations tax return), 1120S (S-Corporation tax return), and 7004 (the corporate income tax extension) to be submitted electronically.

Beginning in March 2007, North Carolina plans to participate in the corporate Fed/State e-file program. (For more information on the implementation of the program by form number, see the specific responses to question 10(d)(i)(1-3), below.) Corporations will be able to pay their tax liability when filing the return electronically but will not be able to receive direct deposit of their refunds.

i) Indicate when the North Carolina EFT program will be rolled out for:

1. Sub-Chapter C corporations

Response: March 2007 for taxable years beginning on or after 1/1/06

2. Sub-Chapter S corporations

Response: March 2007 for taxable years beginning on or after 1/1/06

3. Sub-Chapter K partnerships

Response: No scheduled implementation date. The Department will use the platform built for corporate electronic filing to implement the partnership electronic filing.

ii) Indicate the specific tax years that will be subject to the North Carolina EFT program.

Response: See the responses to question 10(d)(i)(1-3), above.)

iii) Indicate the specific Department forms that are expected to be available for the North Carolina EFT program.

Response: Form CD-405 (C-corporations)
Form CD-401S (S corporations)
Form CD-425 (Corporate Tax Credit Summary Form)
Form CD-419 (Application for Franchise and Corporate Income Tax Extension)

Taxpayers will not be able to file their annual reports through the electronic filing process. Any taxpayer filing its corporate income and franchise tax return electronically must submit its annual report electronically directly to the Secretary of State.

iv) Indicate if there are any “state only options” anticipated for the North Carolina EFT program and its tie to the federal EFT program.

Response: The North Carolina EFT program will support “state only” filing options for the following taxpayers:

- Limited Liability Companies (LLCS), Real Estate Investment Trust (REITS), and Nonprofit entities that file North Carolina forms CD-405 or CD-401S. (Note. These entities file federal forms that cannot be electronically filed with the Internal Revenue Service at this time.)
- Corporations unable to file federal forms 1120 and/or 1120S electronically with the Internal Revenue Service due to federal business rules, i.e. federal reject codes. (Note. Taxpayers must include an electronic copy (“PDF”) of the federal tax return with the North Carolina submission.)

e) Indicate any North Carolina EFT issues which have been designated for taxpayer education and provide an overview of the Department’s plan for providing that education.

Response: The Department continues to believe that taxpayer education is the key to the successful implementation of the Federal/State e-file program. The following list of communication vehicles will be used by the Department to distribute information and update stakeholders on the status of the corporate e-file program:

- DOR Website – Continuous updates and information can be found by going through the Department’s homepage, <http://www.dornc.com>, including a list of approved e-file products, an up-to-date handbook for software developers and tax professionals, and a list of tax professionals authorized to transmit returns electronically to the State.
- E-Alerts – A free web based messaging system created by the Department to update taxpayers and tax professionals on important notices about law changes and related tax matters.
- Tax Practitioner Seminars – The Department along with the Internal Revenue Service conducts several e-file seminars throughout the year. Both the IRS and the Department discuss the rules and regulations of electronic filing and include a “what’s new” section for the upcoming tax season. The Internal Revenue Service sends out registration forms for these seminars each year based on their tax practitioner mailing list.
- Tax The E-file Development Team Help Desk – A helpdesk has been established to provide assistance to taxpayers and tax professionals who have questions concerning participation in the Corporate E-file program. The operating hours are Monday through Friday, 8:00 am to 5:00 pm, except holidays. Software developers, transmitters, and electronic return originators may call the E-file help desk at 1-877-308-9103 or (919)-733-1674 for assistance.