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# 2025 NORTH CAROLINA STATE TAX UPDATE

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## Introduction

We saw very little legislative action in 2024 and practically nothing in 2025.

One of the most notable changes for 2024 was the reintroduction of the corporate and individual nonrefundable tax credit for certain real property conservation efforts. The other noteworthy 2024 item was a modification to North Carolina's codification of the "economic nexus" threshold concept following the Supreme Court's decision in South Dakota vs. Wayfair, Inc.

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

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

Please note that this manuscript went to print on **October 21, 2025**, 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 Increased Standard Deduction Amounts.

| Filing Status | 2024 Standard Deduction Amounts | 2025 Standard Deduction Amounts |
|---|---|---|
| Single | $12,750 | $12,750 |
| Married filing separately And Surviving Spouse | $12,750 | $12,750 |
| Married filing jointly | $25,500 | $25,500 |
| Head of Household | $19,125 | $19,125 |

### II. New Individual Tax Rates.

| Tax Year | Tax Rate |
|---|---|
| 2023 | 4.75% |
| 2024 | 4.5% |
| 2025 | 4.25% |
| 2026 | 3.99% |
| 2027 | ????? |

**A. What About After 2026**? After 2026, if the following North Carolina's General Fund Revenue targets are met, then the personal income tax rate for the subsequent year will lower by one-half of a point, with 2.49% being the lowest rate:

| Fiscal Year | Trigger Amount | Taxable Year Beginning |
|---|---|---|
| FY 2025-2026 | $ 33,042,000,000 | In 2027 |
| FY 2026-2027 | $ 34,100,000,000 | In 2028 |
| FY 2027-2028 | $ 34,760,000,000 | In 2029 |
| FY 2028-2029 | $ 35,750,000,000 | In 2030 |
| FY 2029-2030 | $ 36,510,000,000 | In 2031 |
| FY 2030-2031 | $ 38,000,000,000 | In 2032 |
| FY 2031-2032 | $ 38,500,000,000 | In 2033 |
| FY 2032-2033 | $ 39,000,000,000 | In 2034 |

If there are years where North Carolina does not hit revenue goals, the personal income tax rate will remain the same, but no personal income tax rates cuts will be reversed once they occur.

The soonest the personal income tax rate could drop to 2.49% would be 2029, on the condition of the revenue hitting the "trigger amount" every year.

For reference, North Carolina fund revenue was $34.56 billion for the 2024-2025 Fiscal Year, $33.535 billion for the 2022-23 Fiscal Year, and $33.69 billion for 2023-2024 fiscal year.

**B. Withholdings.** Note that, under N.C.G.S. 105-163.2(b)(1), the withholding rates on wages are the rates scheduled above **plus** .1%.

## III. The Reintroduction of the Real Property Conservation Credit.

Before 2017, North Carolina corporate and individual income tax rules provided for a nonrefundable income tax credit for certain real property donations for conservation purposes. However, the real property conservation credit was repealed for tax years beginning in 2016.

Senate Bill 355 (S.L. 2024-32) has resurrected the real property conservation credit for two (2) years. The amount of the credit is equal to 25% of the fair market of value real property located in North Carolina and donated for conservation purposes. The amount of the credit is capped at $200,000 for individual taxpayers and $500,000 for corporations.

However, the new rule little slightly modifies the property eligibility requirements that are different now than under the pre-2013 law. N.C.G.S. 105-130.34 and 105-153.11.

Also, the maximum amount of credits allowed in a year to all qualifying taxpayers is limited to $5 million, which means that the credits will be prorated for credit applications (due on April 15) that exceed $5 million in total.

The credit is available only in 2025 and 2026.

## IV. North Carolina Tax Treatment of Federal Student Loan Forgiveness.

### A. Background

The United States Department of Education is responsible for the administration of certain programs that allow borrowers forgiveness of their outstanding student loan liability in certain circumstances.

### B. Federal American Rescue Plan Act of 2021 and IRC Section 108(f)(5)

President Biden has directed the Department of Education to create a new student loan forgiveness plan.

Federal Tax Code Section 108 provides for the tax consequences of forgiveness of student debt. Prior to the American Rescue Plan Act of 2021 ("ARPA"), Section 108(f)(5) excluded, from federal gross income, certain student loan debt discharge that arose as a result of the death or total and permanent disability of a student.

In 2021, the ARPA amended Section 108(f)(5) by temporarily expanding the types of student debt forgiveness that would be excludable from federal taxable income. Under the new modified Section 108(f)(5), virtually any student loan debt discharge for taxable years beginning on or after January 1, 2021, and ending before December 31, 2025, will be excludable from federal gross income regardless of the reason for the debt discharge.

### C. North Carolina Decoupling.

North Carolina did not adopt Section 108(f)(5) as expanded by the ARPA for purposes of the application of the state income tax laws. Therefore, under N.C.G.S. 105-153.5(c)(22), North Carolina taxpayers must make an AGI "add back" for the amount of student loan forgiveness excluded from federal gross income under Code Section 108(f)(5).

However, if the taxpayer is "insolvent", then the amount of the North Carolina "add back" is limited to the amount of discharged student loan indebtedness excluded from AGI under Section 108(f)(5) that **exceeds** the amount of the discharge indebtedness that would have been excluded under the general insolvency exception of Section 108(a)(1)(B).

Note that student debt forgiveness arising due to the death or disability of the student is fully exempt from federal and North Carolina taxation.

### D. North Carolina Issues Important Notice: State Tax Treatment of Federal Student Loan Forgiveness.

On December 14, 2022, North Carolina Department of Revenue issued its Important Notice to describe how the new North Carolina student loan forgiveness rules will work.

## V. Certain North Carolina Military Retirement Benefits and Survivor Benefit Plan Payments are Exempt from NC Taxation.

**A. General Rule.** The general rule is that military retirement payments are includable in gross income for federal tax purposes, and therefore are taxable for North Carolina tax purposes as well.

On November 18, 2021, North Carolina enacted **Session Law 2021-180** which contained a new provision that allowed certain eligible retired armed forces members to deduct certain military retirement pay when calculating their North Carolina taxable income. In addition, the new law also allows certain "eligible beneficiaries" of a survivor benefit plan ("SBP") to deduct certain SBP payments **beginning in the year 2021.**

These new changes are effective beginning with the 2021 tax year.

**B. New Deduction For Certain Military Retirement Benefits.** Under new N.C.G.S. 105-153.5(b)(5a), the following items of military retirement pay and survivor benefits are deductible for (nontaxable) North Carolina tax purposes based upon the following:

**1. Certain Retirement Payments.** Retirement pay for retired members of the US Armed Forces who meet either of the following requirements:

**A.** Served at least twenty (20) years; **or**

**B.** Are medically retired under 10 USC Chapter 61. Note that "medically retired" does not include severance pay received due to normal separation from service; severance pay is never eligible for the deduction.

**2. No 20-Year Service Requirement for Medically Retired Service Members.** Also note that the twenty (20) year service requirement does not apply to benefits paid to a medically retired service member. So, in the case of a medically retired service member, the deduction is available regardless of length of service.

**3. No Deduction For Retirement Benefits Payable to Any Person Other than the Retired Service Member.** Also note that the deduction for retirement pay benefits only applies to the actual retired service member, and does not apply to retirement benefits paid to a third-party beneficiary such as a surviving spouse.

**C. Survivor Benefits.** Likewise, under the new rules, a beneficiary of a retired member may be eligible to deduct payments received from a plan that qualifies as a "Survivor Benefit Plan", or SBP, under Federal Law 10 U.S.C. 1447. Generally, a SBP allows a retired member to **purchase coverage** that provides income for an eligible beneficiary.

In these cases, if the retired service member served at least twenty (20) years in the military **or** was medically retired, then the beneficiary of a SBP payment can deduct that payment from North Carolina taxable income.

**D. Effective Date.** The provisions are effective beginning in 2021, so be sure to amend any already-filed 2021 tax return to take advantage of the new deduction.

**For more information, please see "Important Notice: North Carolina Enacts New Deduction for Certain Military Retirement Pay and Survivor Benefit Payments (May 2, 2022) (updated August 5, 2022)."**

## VI. North Carolina's Changes to the Late Payment Penalty Rates

In general, N.C.G.S. §105-236 (a)(4) assesses a late payment penalty if all of the tax is not paid by the due date of the return. The penalty is equal to a percentage of the net tax underpayment.

Session Law 2021-180 contained legislation to change the calculation of the penalty from the then current flat rate of ten percent (10%) to a graduated rate. The change was to be effective for taxes assessed on or after July 1, 2022.

However, the North Carolina Department of Revenue's existing software was not able to accommodate this quick change. So, the old penalty rate of ten percent (10%) continued through December 2022, and then it was reduced to five percent (5%) per month (with a maximum of 25%) beginning in January 2023.

Under Session Law 2022-13 (House Bill 83), the 2% per month graduated rate was supposed to take effect in June 2024, but now that has been postponed until June 2027 due to ongoing software challenges.

So, the temporary five percent (5%) per month rate (with a maximum of 25%) continues to apply until June 2027. Then, beginning in July 2027, a graduated penalty rate applies equal to 2% per month for each month the tax is not paid, up to a maximum penalty of 10%.

## VII. New Cancer Donations for North Carolina Tax Refunds.

Senate Bill 628 (2017) added a new Section 105-269.8 to the individual tax refund provisions to provide that, if any individual is entitled to a North Carolina tax refund, then that taxpayer may elect to contribute, to the North Carolina Division of Public Health of the Department of Health and Human Services, all or any part of that tax refund for early detection of breast and cervical cancer research.

This new cancer donation provision became effective for the 2017 tax year, and was scheduled to expire after the 2020 tax year. However, under House Bill 1080, through 2025, taxpayers may still designate a portion of their North Carolina tax refund to be contributed for breast or cervical cancer research. This provision was set to expire at the end of 2020, but has now been extended through 2025. N.C.G.S. 105-269.8(c).

## VIII. Review of North Carolina Itemized Deductions.

North Carolina allows the following itemized deductions:

1. Charitable contributions. N.C.G.S. 105-153.5(a)(2)a.

2. Qualified residence interest and real property taxes are deductible, but only up to $20,000 in combined total. N.C.G.S. 105-153.5(a)(2)b.

3. Medical expenses deductible under IRC Section 213.

4. "Claim of right" deductions for amounts repaid during the tax year that were included in federal taxable income in a previous tax year.

> **Note:** Individual taxpayers who use the standard deduction for federal tax purposes can still itemize deductions for North Carolina tax purposes. N.C.G.S. 105-153.5(a).

## IX. North Carolina "Decoupling" From the Federal PATH Act and Federal TCJA of 2017.

SB 276 (2016) provided for several instances in which North Carolina did not adopt several of the 2015 federal PATH Act changes to individual income tax. Likewise, the 2018 North Carolina Appropriations Act contained a number of provisions that "decouples" the North Carolina tax code from the Federal Tax Cuts and Jobs Act of 2017. Therefore, we continue to have additional adjustments or variances that will be required for North Carolina tax purposes.

**A. Qualified Opportunity Zone Provision.** The TCJA provides for temporary deferral of gross income for gains reinvested in a Qualified Opportunity Zone fund and the permanent exclusion for capital gains from the sale or exchange of an investment in the QO Fund as long as the investment in the fund is held for at least 10 years. A Qualified Opportunity Zone is a low-income community designated as a QO Zone by the governor of each state.

Senate Bill 99 (2018) decouples from the federal provision by adding new adjustments to N.C.G.S. 105-130.5. New section 105-130.5(a)(26) now provides for a North Carolina addition to taxable income for gain otherwise excluded under Section 1400Z of the Internal Revenue Code. Likewise, N.C.G.S. 105-130.5(b) also provides for a subtraction from gross income to the extent that gain from sale of a QO Fund has to be recognized in a subsequent year under Section 1400Z of the Internal Revenue Code.

## PART TWO

## REVIEW OF FEDERAL AND STATE DIFFERING TREATMENT OF SECTION 168 AND 179 DEDUCTIONS

### I. Section 179 Limitations for 2016 and Beyond: SB 726 (Session Law 2016-6, June 1, 2016).

**A. Old Federal Law.** For 2024 federal tax purposes, the Section 179 expense limit was $1.22 Million (adjusted for inflation) and the federal Section 179 expense deduction was "phased-out" for annual purchases above $3.05 Million.

**B. SB 276 Section 179 Limits and Phase-Out.** Nevertheless, SB 276 provided for North Carolina Section 179 limitations and a phase-out threshold for North Carolina tax purposes as follows:

1. **North Carolina Section 179 Limits and Phase-Outs.** The North Carolina Section 179 limit is $25,000. N.C.G.S. 105-130.5B. And, under SB 276, the Section 179 deduction will begin being "phased-out" for annual acquisitions above $200,000. N.C.G.S. 105-130.5B(c).

2. **North Carolina 85% Add-back and Subsequent Year 20% Deductions.** As in years past, North Carolina requires that taxpayers must "add back" to Federal AGI for North Carolina tax purposes 85% of difference between the Federal Section 179 deduction and the Section 179 deduction allowed for North Carolina tax purposes. And, for next five (5) years thereafter, North Carolina taxpayers may deduct 20% of the "add back" amount. N.C.G.S. 105-130.5B(c).

**C. New Federal Law.** For 2025 federal tax purposes, the Section 179 expense limit has been increased to $2.5 Million (adjusted for inflation beginning in 2026) and the federal Section 179 expense deduction "phase-out" for annual purchases has been increased to $4 Million (adjusted for inflation beginning in 2026).

### II. No North Carolina Section 168 Bonus Depreciation; SB 276 (Session Law 2016-6, June 1, 2016).

**A. Pre-2025 Federal Law.** The Federal PATH Act extended the 50% Section 168 Bonus Depreciation for 2015, 2016, and 2017. The TJCA increased the Section 168 Bonus Depreciation to 100% of qualified property acquired and place into service after September 27, 2017 and before January 1, 2023.

**B. SB 276 "De-couples" Bonus Depreciation from the Federal Act.** Regardless, on June 1, 2016, Governor McCrory signed SB 276 which did not adopt the federal bonus depreciation rules for North Carolina tax purposes. So, for 2015 and beyond, the North Carolina rules mandate an 85% "add back" for 2015 and thereafter with 20% "add back" deductions over the next five (5) years. See N.C.G.S. 105-130.5B(a).

**C. Post-2024 Federal Law.** The 2025 Federal Act permanently extended the 100% Section 168 Bonus Depreciation.

## III. But, Tax Basis is the Same for Federal and NC Tax Purposes.

Except in the case of certain "carryover basis transfers" as discussed below, the general rule is that there is no difference in the tax basis of Section 179 or Section 168 assets for North Carolina purposes, notwithstanding the NC add-backs for Section 179 write-offs or Section 168 bonus depreciation deductions. N.C.G.S. 105-153.6(d).

## IV. Corporation Forfeits its Bonus Depreciation Deduction Upon Converting to An S Corporation; Bodford v. North Carolina Department of Revenue, North Carolina Superior Court, No. 11 CVS 464 (April 10, 2013).

Here, a C corporation was subject to the North Carolina "add back" for federal bonus depreciation. Later on, the C corporation converted to an S corporation and the S corporation shareholders attempted to take a North Carolina deduction in subsequent tax years for the North Carolina bonus depreciation "add-backs." The NCDOR disallowed the deductions. So, by converting from a C corporation to an S corporation, all of the future North Carolina bonus depreciation deductions were lost forever.

## V. PLR Confirms Married Couple Entitled to Deductions for Accelerated Depreciation "Add Backs" After Taxable Sale of Their Interests in the Pass-Through Entity.

In Private Letter Ruling 2019-2 (November 20, 2019) two married taxpayers owned interests in a pass-through entity. The pass-through entity claimed bonus depreciation deductions over a number of years which the married couple added back to their federal AGI. In subsequent years, the married couple began taking their 20% bonus depreciation "add back" deductions.

The husband decided to sell his interest in the pass-through entity and inquired as to whether he would be entitled to continue to take the 20% bonus depreciation add back deductions in the years after the sale of his interest in the pass-through entity. The NCDOR confirmed that, as long as the sale was not a "Bonus Assist Basis" transfer under N.C.G.S. 105-153.6(e), then the husband could continue to take add back deductions for 5 years after the sale.

## VI. NC Department Of Revenue Clarifies Bonus Depreciation Basis Adjustments Required Upon Property Transfers In Non-Recognition Events.

**A. Introduction**. Special rules apply where property, subject to Section 168 bonus depreciation, is transferred in a nonrecognition event, or where the ownership interests in the owner of property subject to Section 168 bonus depreciation is transferred in a nonrecognition event.

Under N.C.G.S. 105-130.5B(e) (applicable to corporations) and new N.C.G.S. 105-153.6(e) (applicable to individuals), if there is a transfer of an asset where the tax basis of the asset carries over from the transferor to the transferee for Federal tax purposes (such as by virtue of a gift or by a merger, or pursuant to a Section 351 capital contribution to a corporation or a Section 721 contribution to a partnership), the transferee may add any remaining unused 20% "add-back" deductions to the tax basis of the transferred asset, and the transferee may then depreciate the new adjusted tax basis in the property over the remaining useful life of the asset. In all events, however, the transferor is not allowed any remaining future bonus depreciation deductions associated with the transferred asset.

However, in the personal income tax context, the transferee gets the basis addition only if the transferor (or the owner in a transferor) certifies in writing to the transferee that the transferor (or the owner in a transferor) will not take any remaining future 20% bonus depreciation deductions associated with the transferred asset. N.C.G.S. 105-153.6(e). Also, under N.C.G.S. 105-153.6(h), for purposes of this Section, a "transferor" is an individual, partnership, S corporation, LLC or Trust, and an "owner in a transferor" is a partner, shareholder, member of a "transferor."

> **Note:** While the "certification" requirement isn't specifically mentioned in the context of corporate taxpayers under N.C.G.S. 105-130.5B(e), we still recommend going that extra step.

And, remember that, under N.C.G.S. 105-153.6(d), the normal rule is that the adjustments to federal AGI from the bonus depreciation adjustments do not result in an asset tax basis difference for federal tax purposes versus North Carolina tax purposes. However, to the extent there has been a transfer of an asset, the tax basis would be different for federal and North Carolina tax purposes to the extent that the transferee increases its tax basis in the asset for unclaimed 20% deduction amounts. N.C.G.S. 105-153.6(e) and (g).

And finally, please note that, to the extent that the transferred asset has no more useful life left for federal depreciation purposes (and presumably has been depreciated to zero for federal tax purposes), the transferee may claim the transferor's remaining unused 20% depreciation deductions in the year of the carryover basis transfer.

**B. Transfers of a Bonus Depreciation Asset After 2012.** The North Carolina Department of Revenue has issued clarification as to how the bonus depreciation basis "add-back" rules will be applied when there is an actual or deemed transfer of a bonus depreciation asset after 2012 in a non-recognition event. Bonus Asset Basis, North Carolina Department of

Revenue Announcement (February 21, 2014). The Department explains that, in a carryover-basis transfer of a bonus depreciation asset that occurs after 2012, the transferee may add any remaining installments of the five (5) year bonus depreciation deductions of the transferor to the transferee's tax basis of the transferred asset, and the transferee then may depreciate the adjusted tax basis over any remaining useful life of the transferred asset. The Department clarifies that neither the transferor (nor any owner of the transferor) may claim any remaining installments of the five (5) year bonus depreciation deduction after the transfer.

However, the Department advises that, in most cases, the transferee may make an addition to basis **only to the extent** that the transferor (or each owner of the transferor) certifies in writing to the transferee that the transferor (or the owner of the transferor) will not take any future installments of the five (5) year bonus deprecation with respect to the transferred asset.

> **Question:** But what if the transferor is a pass-through entity (such as an LLC or an S corporation) and less than all of the owners of the transferor (say 2 of 5 owners of the pass-through entity) make the required written certification to the transferee?
>
> **Answer:** In informal discussions with the NCDOR, the NCDOR has advised that, in this event, the transferee gets a basis addition **only** for the amount of the excess deductions that have not yet been claimed by the two (2) pass-through owners who issued the written certification to the transferee.

Apparently, however, the bonus asset basis addition is allowed for transfers to C corporation-transferees even if the transferee does not receive the required written certification from the transferor. But for all other transferees, the written certification is required.

***Note: this Notice illustrates the importance of making sure that the transferee receives the certified written certification from the transferor (or its owners) that future bonus depreciation deductions will not be claimed by the transferor (nor by any of its owners).***

C. **Remaining Life.** The Department further advices that the transferred asset has remaining life if it has not been fully depreciated for federal income tax purposes as of the date of the transfer. In that case, the basis adjustment will be recovered over the remaining years in which the assets will be depreciated for federal tax purposes. However, if the asset has no remaining life, then the transferee may fully deduct the transferor's remaining unused 20% deduction amounts in the year of the carryover basis transfer.

D. **Adjustments on State Income Tax Return.** The Department notes that the bonus asset basis adjustment - resulting from the transfer of an asset described above - will result in a difference in tax basis for federal and state tax purposes, as well as a difference in the amount of depreciation or gains or losses for state and federal tax purposes going forward. So, an adjustment to federal adjusted gross income is required for state tax purposes for each year the asset is depreciated or for the year the asset is sold. See N.C.G.S. 105-130.5B(g) and 105-153.6(g).

**E. Examples.** The NCDOR has provided detailed examples of how the carryover bonus asset basis rules apply on Pages 145 through 150 in its 2024 Personal Income Tax Bulletin (February 2025.

## PART THREE
## SUMMARY OF NORTH CAROLINA ADJUSTMENTS TO FEDERAL AGI

### I. Additions To Federal AGI.

Here are **some** of the **Federal AGI additions** that apply for 2020 and thereafter:

1. Interest income from debt obligations of states other than North Carolina. N.C.G.S. 105-153.5(c)(1);
2. Reduction in S corporation shareholder income by virtue of the Federal Section 1374 "built-in-gains" tax. N.C.G.S. 105-153.5(c)(2);
3. 85% "add back" for excess Federal Section 179 and Section 168 deductions. N.C.G.S. 105-153.5(c)(5);
4. For property sold during the tax year, the amount by which the taxpayer's tax basis for Federal tax purposes exceeds the income tax basis for North Carolina tax purposes. N.C.G.S. 105-153.5(c)(3);
5. Deferred gain on sale of property under Section 1400Z;
6. Discharge of student loan debt;
7. Taxed Pass-Through Entity Loss:
8. State tax deducted by a PTE;
9. Federal NOL deduction;
10. Expenses allocable to income exempt or excluded from gross income;
11. Amount of employer provided payment of education loans; and
12. Discharge of qualified principal residence indebtedness.

## II. Overview of AGI Reductions From Federal AGI Under N.C.G.S. 105-153.5(b).

Here are **some** of the Federal AGI **reductions** that apply for 2022 and thereafter:

1. Interest income from U.S. and North Carolina debt obligations. N.C.G.S. 105-153.5(b)(1);

2. Taxable portion of Social Security and Railroad Retirement Benefits. N.C.G.S. 105-153.5(b)(3);

3. Federal and North Carolina retirement benefits that are exempt under the Bailey, Emory and Patton line of cases. N.C.G.S. 105-153.5(b)(5);

4. State and local income tax refunds. N.C.G.S. 105-153.5(b)(4);

5. 20% deduction allowed due to the Section 168 or Section 179 "add back." N.C.G.S. 105-153.5(b)(8);

6. For property sold during the tax year, a reduction to the extent that the taxpayer's tax basis for North Carolina tax purposes exceeds the income tax basis for federal tax purposes. N.C.G.S. 105-153.5(b)(7);

7. For deferred gain later recognized under Section 1400Z;

8. Amounts included in federal taxable income for certain economic incentives;

9. For 2021 through 2025, twenty (20%) percent per year of North Carolina disallowed NOL carryback for 2018, 2019 and 2020;

10. For 2021 through 2025, twenty (20%) percent each year of amount of disallowed federal excess business loss deductions; and

11. For 2021 through 2025, twenty (20%) percent each year for North Carolina add back of excess federal NOL deduction against taxable income for 2018, 2019 and 2020.

12. Beginning in 2021, certain Military Pension Income Payments. SB105 (2021).

13. Business interest limitation.

14. Taxed Pass-through entity income.

15. Excess business loss.

See revised N.C.G.S. 105-153.5(c2).

## PART FOUR
## NORTH CAROLINA FIDUCIARY INCOME TAX DEVELOPMENTS

### I. North Carolina Income Taxation of Foreign Trusts With North Carolina Beneficiaries.

North Carolina assesses income tax on the income of a foreign trust holding assets for the benefit of one or more North Carolina residents, **even where** (1) the trustee is not a North Carolina resident, (2) the trust's assets are held outside North Carolina, and (3) the Trust instrument provides that the Trust is governed by the laws of a state other than North Carolina. Specifically, North Carolina General Statute Section 105-160.2 imposes income tax on the amount of taxable income of a trust that is "for the benefit of a resident of North Carolina." Moreover, North Carolina Administrative Code requires a fiduciary to file a North Carolina income tax return if a trust derives any income for the benefit of a North Carolina resident. 17 NCAC 6B.3716(b)(2).

### II. The Kaestner Trust Case.

On June 21, 2019, the United States Supreme Court delivered its much anticipated decision on the Kaestner Trust case, affirming the North Carolina Supreme Court's decision that N.C.G.S. 105-160.2 was unconstitutional "as it applied" to one of the North Carolina beneficiaries of an out-of-state trust. North Carolina Department of Revenue vs. Kimberly Rice Kaestner 1992 Family Trust, 39 S. Ct. 2213 (2019).

Previously, the NCDOR appealed the North Carolina Supreme Court's decision that N.C.G.S. 105-160.2 was unconstitutional "as it applied" to a North Carolina beneficiary of an out-of-state trust. Kimberly Rice Kaestner 1992 Family Trust vs. North Carolina Department of Revenue, 814 S.E.2d 43 (N.C. 2018). The U.S. Supreme Court concluded that such taxation is unconstitutional "as applied" to the Kaestner Family Trust, where the only connection of the foreign trust to North Carolina was the North Carolina residence of the trust's discretionary beneficiaries.

A. **Facts.** In the Kaestner Family Trust case, Joseph Lee Rice III created an irrevocable trust in 1992 for the benefit of his children. The Trust was created in New York and was governed by New York law. When the Trust was initially created, Mr. Rice and the trustee all resided and were domiciled in New York. Also, at the time the Trust was created, no primary or contingent beneficiary was a resident or domiciliary of North Carolina. In 1997, Mr. Rice's daughter, Kimberly Rice Kaestner, moved to North Carolina.

During the relevant tax years at issue, the Trust invested in financial investments and the custodian of the Trust's assets was located in Boston, Massachusetts. All legal, tax and financial books and records for the Trust were prepared in New York.

Under the terms of the Trust, neither Ms. Kaestner nor any of the beneficiaries had the absolute right to demand any of the assets or income of the Trust. Instead, distributions of income and principal could be made by the Trustee at its "sole discretion." Indeed, during the tax years at issue, no distributions were made from the Trust to North Carolina beneficiaries.

During the 2005 through 2008 tax years, the Trust filed North Carolina income tax returns and reported, as taxable income, Ms. Kaestner's share of the income accumulated in the Trust, even though no income was actually distributed to Ms. Kaestner or to her children. The Trust then filed a refund request to request a refund of income taxes from North Carolina of over $1.3 Million paid by the Trust during those tax years. The NCDOR denied the refund request and the Trust filed a law suit in Wake County, North Carolina Superior Court, claiming that N.C.G.S. 105-160.2 violated the Due Process and Commerce Clauses of the United States Constitution, as well as the Constitution of the State of North Carolina.

**B. The Due Process Challenge.** According to the Supreme Court, in determining whether the North Carolina statute violated the Due Process Clause of the United States Constitution, the court must focus on the Trust's contacts and relationships with North Carolina, rather than focus upon the beneficiary's contacts with North Carolina.

Here, the Trust never had any physical presence in North Carolina, never owned any real property located in North Carolina and never invested directly in any North Carolina based investments. Also, the Trust never kept any records in North Carolina as the principal place of administration of the Trust was outside the State of North Carolina.

Since the Trust never had any physical contacts with North Carolina, the Court then reviewed and scrutinized whether there were any benefits conferred upon the Trust by North Carolina to determine whether North Carolina has constitutional authority to tax income held by the Trust. The court viewed whether the Trust had "purposely availed" itself of the benefits and laws of North Carolina such as by keeping tangible or intangible property in North Carolina or by using property in North Carolina or by conducting business in North Carolina.

Previously, the Superior Court of Wake County suggested that, with respect to the actions of the Trust, the maintenance of an office in North Carolina, the ownership of assets in North Carolina, and the transaction of business in North Carolina might provide sufficient contacts to permit the taxation of trust income. However, the court noted that the only connection between the Trust and North Carolina was the fact that Ms. Kaestner and her three children lived in North Carolina.

**C. Commerce Clause Challenge.** Likewise, for the same reasons, the Wake County Superior Court also found that, with respect to the Commerce Clause challenge to the statute, the Trust lacked "substantial nexus" with North Carolina and therefore the statute violated the Commerce Clause of the United States constitution "as applied" to the Trust in this case.

**Note:** The NCDOR appealed the Superior Court's decision regarding the Commerce Clause to the North Carolina Court of Appeals, but the Court of Appeals did not address the Commerce Clause issue on appeal. Thus, on appeal to the North Carolina Supreme Court, the Supreme Court dealt only with the Due Process challenge.

**D. Conclusion.** There are several important observations to be drawn from this case. First of all, the Supreme Court affirmed that the North Carolina fiduciary income statute was unconstitutional "as applied," rather than "on its face." If the Supreme Court had ruled that the North Carolina statute was unconstitutional "on its face," then virtually any out-of-state trust, that pays North Carolina tax, could seek a refund of income taxes paid to North Carolina based upon the Kaestner Trust decision. However, this case may have very little precedential value to other out-of-state trusts, since the tax was deemed unconstitutional only "as applied" to the Kaestner Trust.

Finally, the NCDOR was unable to show any physical connection or business connection between the Trust and the State of North Carolina. The Court may well have reached a different result if the Trust had invested in any assets or businesses located in, or operating in North Carolina.

## III. Testamentary Trust Not Subject to North Carolina Taxation. June 21, 2021 – Request for Written Determination issued June 1, 2021.

Trust established by North Carolina resident prior to his death.

**Facts:** Trust does not own any real estate and does not participate in any partnership or business activities. Trust income is only from intangible investments, none of which are "North Carolina based."

No trust beneficiaries are residents of North Carolina.

**Ruling:** Trust is not required to file North Carolina fiduciary income tax returns, regardless of whether income is distributed to beneficiaries or retained by the trust, because the trust neither (1) derives income from NC sources nor (2) derives any income for the benefit of a North Carolina resident.

**Note:** PLR does not indicate whether (1) trustee or (2) investments are located inside or outside of North Carolina.

# PART FIVE
# SPECIAL STATE TAX ISSUES FOR EMPLOYEES WHO TELECOMMUTE OR WORK REMOTELY AND FOR THEIR EMPLOYERS

## I. Introduction.

When Covid hit, many employers sent their workers home and many of those employees elected to move to another state during the Covid pandemic. Many employees discovered that they could work effectively and efficiently through a home office outside of their employer's state.

Since the end of the worst part of the Covid crisis, employees have been reluctant (or altogether unwilling) to return to their employer's location and have continued to work remotely.

As this Part will discuss, there are many state tax issues that affect both the employer and the employee where employees decide to work remotely in another state outside the employer's state of business.

## II. Concerns for the Employer.

A. **Nexus Implications for Telecommuting Employees:** For employers who have employees telecommunicating out of state, these telecommunicating activities can create "nexus" in new states. Although Public Law 86-272 prohibits states from assessing income tax on business where the only activity of that business is solicitating out-of-state sales for the purchase of tangible property, this protection under PL 86-272 does not protect employers who have employees located in another state. So, the mere fact that an employee is located in another state can create nexus between that employer and the other state, irrespective of PL 86-272.

Likewise, the protections under the U.S. Supreme Court Wayfair decision may not provide any relief for the employer.

For example, assume an employer is not collecting and remitting sales tax in state "X" based upon the Wayfair matrix of less than 200 transactions during the year or less than $100,000 of sales in that state during the year. However, this is merely "the economic presence" test as approved by the US Supreme Court in Wayfair and does not have any bearing on the "physical presence" nexus test. So, even if an employer's activities in another state do not rise to the level to establish "economic presence" in that state, the employer can still be subject to nexus in that state, based upon the "physical presence" test by virtue of having an employee who lives and works in that other state.

During the pandemic, many states agreed to "temporarily" suspend corporate and sales and use tax nexus thresholds, as the pandemic forced some employees to work remotely in another state. However, the key word here was "temporarily", and now that pandemic restrictions have been lifted, we may see those states reaching out to establish "nexus" where a remote worker continues to live and work in that state post pandemic.

**B. Income Tax Withholding Obligations:** Generally, employers must withhold and remit state income taxes to the state where the employee is performing services for that employer (i.e., to the state where that employee is sitting). In fact, employers can be held liable for failing to withhold state tax on wages attributable to the employee's work state location. This means the employer is forced to ascertain their employees' work locations, regardless of the state where the employer's business is located.

**C. Workers' Compensation and Unemployment Tax Issues:** Where employees work in a state other than the state of their employer, the employer must also be concerned about workers' compensation insurance and unemployment insurance issues. The general rule in most states is that employers must obtain workers' compensation insurance in the state where the employee is actually working and must also pay unemployment compensation to that state. This adds additional complexity to many situations where employees are working remotely out of state.

## III. Concerns for the Employee.

For remote employees that work from home for an out-of-state employer, there are different sets of rules that typically apply. Many states do not assess income taxes on employees that work out-of-state from home. So, for example, if an employee works in Florida for an employer outside of Florida, then it is entirely possible that the employee could escape state taxation on their wages altogether.

Other states, however, are not so employee friendly, but instead will assess income tax on the employee based upon whether the employee is working out-of-state under the "convenience of the employer" rule, where the employee's compensation will be treated as having been earned as if the work was performed in the employer's location, regardless of where the employee is located when the employee provides those services.

**A. Withholding Rules for Telecommuting Employees:** Generally, most states have determined that the employee's physical presence dictates where the tax is due. This means that, if an employee is working in North Carolina for an out-of-state employer, then the typical rule is that North Carolina gets the income tax withholding. However, other states, (Alabama, Connecticut, Delaware, Massachusetts, Nebraska, New Jersey, New York and Pennsylvania) impose something called the "convenience of the employer" rule and under the "convenience of the employer" rule, if the employer is located in one of those states, then the tax withholding obligations may have to be paid as if the employee was located in one of those states.

**B. The "Domicile Rule" and the "183-Day Per Year Rule":** Some states have a "domicile rule" as well as a "183-day per year" rule. Remember, "domicile" is only changed when a person abandons the original state of domicile and then adopts another state as the new state of domicile.

For example, in New York, if a person is deemed "domiciled" in New York, then New York taxes all of that person's worldwide income. In addition, other states (such as New York

and Connecticut) also apply a "183-day" rule for nonresidents. In these states that impose the "183-day" rule to nonresidents, a nonresident is subject to that state's income tax on worldwide income if that person merely resides 183 days in that state, even if that person is domiciled in another state.

**C. <u>The Convenience of the Employer Test.</u>** Some states (such as NJ, NY, CT, DE, NE and PA) also impose something called the "Convenience of the Employer Rule" for out-of-state remote workers. New York is an example of a state that uses the "Convenience Rule".

Under the Convenience Rule, where an employer is located in one state (e.g., NY), but has an employee who works remotely in another state (e.g., Florida), the employer's state of location (NY) will subject the remote worker to taxation in the employer's state (e.g., NY) if the worker worked remotely out of state for his own his\her own convenience rather than that of the employer.

So for example, an employee of a New York employer, who decides to work remotely out of worker's vacation condo in Florida, would be subject to New York income tax withholding on all wages earned by that person by virtue of the fact that he\she is working in Florida merely for his\her own convenience.

On the other hand, there may be certain circumstances were business necessity or business purpose can defeat the "Convenience" rule. In the example above, if the employee had to work remotely in Florida to call on sales customers of the New York company, then the New York State taxing authorities may not be able to reach the wage income earned by that individual working out of Florida because of the needs of the employer business .

**D. <u>Alabama's "Engaged in Business" Rule For Nonresident Workers</u>:** Recently, the Alabama Tax Tribunal issued two (2) decisions holding that an out-of-state resident was subject to Alabama income tax on Form W-2 wages paid by an employer located in Alabama, even though the worker was domiciled and resided in another state.

In <u>Bollinger</u>, Alabama Tax Tribunal, Dkt. No. INC 22-390-LP (March 8, 2023) and <u>Baty</u>, Alabama Tax Tribunal, Dkt. No. INC. 22-928-LP (May 19, 2023), the Alabama Tax Tribunal confirmed that both taxpayers in those cases were no longer residents of Alabama after they had abandoned their Alabama domicile and had adopted a new state (Idaho in the <u>Bollinger</u> case and Florida in <u>Baty</u> case) as their new state of domicile. In both cases, however, after abandoning Alabama as their domicile state, each taxpayer kept working for their employer who was located inside the State of Alabama.

The Alabama Tax Tribunal concluded that each non-resident taxpayer was "engaged in business" in Alabama by engaging in "regular and legal employment" with its employer which was located in Alabama. The fact that the taxpayers provided those services outside of Alabama was irrelevant to the Alabama Tax Tribunal.

Alabama Code Section 40-18-2 provides that every "non-resident individual receiving income from property owned or business transacted in Alabama" is subject to Alabama income tax. See also Alabama Administrative Code Section 810-3-14-.05(1)(a).

In both cases, the Alabama Tax Tribunal found that the taxpayers continued to "transact business" in Alabama via their employment with an Alabama-based employer, and that their Form W-2 wage income earned from an Alabama employer was "Alabama sourced income" and thus taxable in Alabama.

North Carolina has a statutory framework very similar to that in Alabama. N.C.G.S. 105-153.8(2) sets forth the income tax return filing requirements of a non-resident and obligates a non-resident to file a North Carolina income tax return if the non-North Carolina resident has gross income "derived from a business, trade, profession, or occupation carried on in this state …" Also see N.C.G.S. 105-153.2(2) and NCGS 105-153.4(b) for the concept of North Carolina taxation of income "derived from … an occupation" carried on in North Carolina.

**E. Tax Credits and the Potential For Double Taxation.** Some states provide a tax credit for state income taxes paid on income earned in another state. However, some states do not recognize the 183-day Residency Rule of other states. The result of all this is that a taxpayer residing in one state, but domiciled in another state, could well be subject to double state taxation on the same wage income earned in the same tax year.

Likewise, some states subject all intangible income (interest, dividends, capital gains, etc.) based upon whether the taxpayer meets the domicile test **or** the residency test for that year. This means that a taxpayer earning intangible income (interest, dividends, capital gains) could be subject to double state taxation where domiciled in one state but residing in another state that imposes the 183-day residency rule.

## IV. Conclusion.

Unfortunately, there are no hard and fast rules as to the consequences to the employer and the employee where a worker works remotely out-of-state. If you want to learn more, there is an excellent article published in the September 2021 issue of the "CPA Journal", written by Mark Klein, Joseph Endres and Katherine Piazza.

# PART SIX
# CONTINUED STATE CHALLENGES TO FEDERAL LIMITS ON DEDUCTIONS FOR STATE AND LOCAL TAXES

## I. Background

Section 11042 of "The Tax Cuts and Jobs Act," Pub. L. No. 115-97, limits an individual's deduction under §164 for the aggregate amount of state and local taxes paid during the calendar year to $10,000 ($5,000 in the case of a married individual filing a separate return). State and local payments in excess of those amounts are not deductible. This new limitation applies to taxable years beginning after December 31, 2017 and before January 1, 2026.

## II. Second Circuit Rules SALT Limits are Constitutional

The 2017 Tax Cuts and Jobs Act capped the state and local tax ("SALT") deduction at $10,000 per year. In 2018, the states of New York, Connecticut, Maryland, and New Jersey filed a lawsuit arguing that the SALT deduction cap was unconstitutional for a number of reasons.

In September 2019, the federal district court dismissed the lawsuit, holding that the SALT cap was not unconstitutionally coercive and did not interfere with states' rights and sovereignty. The states appealed, and on October 5, 2021, a three-judge panel of the Second Circuit Court of Appeals unanimously affirmed the trial court's dismissal of the states' claims and held that the SALT deduction cap was not unconstitutional. The case citation is New York v. Yellen, No. 19-3962-cv, 2021 U.S. App. LEXIS 29862 (2d Cir. Oct. 5, 2021).

## III. States Continue Efforts to Find a "Work-Around".

Ever since the 2017 Tax Cuts and Jobs Act introduced the $10,000 limitation on an individual's ability to take an itemized deduction for state and local taxes, commonly known as the SALT cap, states have been trying to find a workaround. States have tried several different options with no avail.

### A. State Tax Donation Credits Don't Work.

One common SALT cap workaround that states tried to adopt early on involved classifying state tax donation credits as deductible charitable contributions for federal income tax purposes. The idea was that state legislatures would adopt legislation that would allow taxpayers to make transfers to funds controlled by state or local governments, in exchange for credits against the taxpayer's state or local income taxes. The goal was to subsequently allow the taxpayer to characterize such transfers as fully deductible charitable contributions on the taxpayer's federal income tax return.

This seemed like a quick and easy workaround, as the state still received the necessary income for tax purposes, while allowing the taxpayer to receive an offsetting federal income tax deduction. Well, the IRS was quick to question this approach when it issued Notice 2018-54 announcing that it would take a substance-over-form approach regarding such transfers.

Ultimately, the IRS shot down this idea entirely when it issued Treasury Decision 9864 making it clear that a taxpayer making payments to an eligible state or local entity in exchange for state or local income tax credits, must reduce the amount of the taxpayer's federal charitable contribution deduction by the amount of any state or local tax credit that the taxpayer receives or expects to receive.

Oh well, so much for that idea. At least you can't blame the states for trying.

### B. <u>But, What About a Pass-Through Entity Deduction</u>?

But then the concept of a pass-through entity tax, or PTE Tax, received the Treasury and the IRS blessing via Notice 2020-75 on November 9, 2020.

Under the PTE Tax, the state and local income taxes imposed on a partnership or S corporation's income are paid by the entity directly, rather than by the individual owner. Because the SALT cap applies only to personal income taxes, not income taxes paid by businesses, then the SALT cap is lifted for that income. As a result, the tax payments made by the entity are deductible against the entity's taxable income, thus effectively resulting in a federal tax deduction to the entity's owners.

In Notice 2020-75 (Nov. 9, 2020), the IRS approved the PTE tax to avoid the SALT cap. IRS Notice 2020-75 (November 9, 2020) specifically describes how the IRS will bless certain state enacted SALT workaround plans.

# PART NINE
# OVERVIEW OF NORTH CAROLINA PTE (PASS-THROUGH ENTITY) DEDUCTION RULES

## I. Background: North Carolina Adopts the PTE Approach As a Work-Around to the SALT Cap Beginning in 2022.

SB 105 adopted the PTE SALT cap workaround approach beginning with the 2022 tax year.

Beginning with the 2022 tax year, an S-Corporation or partnership may elect to pay SALT (state and local tax) at the entity level, instead of at the personal level, to avoid the $10,000 federal cap on SALT deductions on 1040 schedule A. If such an election is made, the PTE will be subject to tax on its North Carolina taxable income at the individual income tax rate.

On November 18, 2021, North Carolina adopted Session Law 2021-180 that clarified how the new SALT workaround would work for North Carolina taxpayers. Of course, this is only a partial workaround on the SALT limits because this only applies to benefit taxpayers who are owners of LLCs and S corporations. In the new North Carolina SALT workaround, Partnerships and S Corporations may elect to pay the North Carolina income tax at the entity level on behalf of their owners.

## II. North Carolina Publishes Its 2022 and 2023 Important Notices and General Assembly Passes SB 174 (Session Law 2023-12) (April 3, 2023).

On April 14, 2022, North Carolina issued its "Important Notice Regarding North Carolina's Recently Enacted Pass-Through Entity Tax" and provided a "Question and Answer" format explanation of how the new PTE deduction in North Carolina will work. The Important Notice was later re-issued and updated on November 15, 2022, and again on December 2, 2022.

The original Important Notice acknowledged there were many unanswered questions as to how the PTE rules in North Carolina will work in different fact situations. In various places, the April 2022 Important Notice stated that more guidance would be provided once North Carolina issued its instructions to 2022 tax returns.

Then, on April 3, 2023, SB 174 (Session Law 2023-12) was enacted to make some **retroactive and prospective changes** to the PTE rules. On April 4, 2023 the NCDOR published another Important Notice explaining these changes to the PTE rules.

Under SB 174 (Session Law 2023-12), **effective as of January 2022**, eligible owners of an electing partnership include other partnerships and S corporations.

Also, effective as of **January 1, 2022**, new changes were enacted for partnerships operating outside of NC. Under the new changes, North Carolina owners of a partnership can claim a North Carolina tax credit for income taxes paid by the PTE to another state, as long as the partnership is not a North Carolina PTE. However, if the PTE **is** a North Carolina PTE, then

**only** the PTE can claim a credit for taxes paid to the other state.

And finally, SB 174 modified the adjustments required for owners of **multi-state PTE's, effective as of January 1, 2023**. Under the new rules, effective as of January 1, 2023:

(a) A North Carolina PTE is only taxed on that part of its income that is allocable to North Carolina (which eliminates any need for any North Carolina credit for PTE tax paid to another state); and

(b) There are two (2) deductions for North Carolina owners of NC PTE's:

**(1)** A deduction for NC income taxed by NC at the PTE level; and
**(2)** A deduction for income taxed by other states at the PTE level.

Then, in October 2023, House Bill 259 (Session Law 2023-134) was enacted to further expand the types of eligible owners of a PTE partnership to include (i) certain types of trusts eligible to elect to be qualifying shareholders of an S corporation and (ii) C corporations.

## III. Making the PTE Election.

The Important Notice advised that the PTE election must be made on a timely filed tax return, **including** extensions. This means that every PTE should file a federal extension **and** a North Carolina extension request as a safeguard in case something gets screwed up with the federal extension election. We routinely recommend that every PTE extend all of their tax returns for federal and North Carolina tax purposes, even if the return is otherwise ready be filed by the normal date due date.

## IV. How to Make the PTE Election.

The PTE election is made at the entity level and qualifying entities can switch back and forth each and every year. So, making the PTE election in one year doesn't obligate you to make this PTE election the next year.

Note that the PTE election must be made for **all** owners of the PTE. In other words, you can't make the PTE election for the benefit of some, but not all, of the owners.

## V. Payment of the PTE Tax; Rules for Accrual Basis Taxpaers.

Under the PTE regime, the PTE pays North Carolina income tax on its taxable income at the flat individual income tax rate in North Carolina. This is so regardless of whether the individual PTE owners may be subject to a lower effective North Carolina tax rate due to their own available credits, deductions, etc.

Note that "payments" of PTE tax for a current year **cannot be accrued**, but instead the PTE will actually have to make the estimated tax payments prior to the end of the current year.to generate a deduction in the current year, even if the taxpayer otherwise uses the **accrual method of accounting for tax purposes.**

## VI. Eligible Pass-Through Entities.

Eligible pass-through entities include certain Partnerships and **all** S corporations. Partnerships are eligible to make the PTE election only if all of its partners are "qualifying owners". "Qualifying owners" of a partnership are defined as:

(1) Individuals;
(2) Estates;
(3) Trusts "eligible" to hold S corporation stock (regardless of whether a QSST Election for ESBT Election is in effect);
(4) Tax exempt entities;
(5) S and C corporations; and
(6) other partnerships.

Disregarded entities are **not** eligible to make the PTE election.

## VII. Special Rules For PTE Partnerships With Pass-Through Partners.

If a North Carolina PTE Partnership has partners which are S corporations or other partnerships ("Pass-Through Partners"), the PTE Partnership cannot include the Pass-Through Partners' distributive shares of North Carolina taxable income when the PTE Partnership calculates its North Carolina taxable income. SB 174; NCDOR Important Notice April 4, 2023. Instead, the NC PTE Partnership treats the Pass-Through Partner as a non-resident Pass-Through-Partner under N.C.G.S. 105-154(d), and the PTE Partnership must pass the Pass-Through Partner's distributive shares of North Carolina taxable income to the Pass-Through Partner. This also means the Pass Through Partner cannot deduct its share of income from the NC PTE Partnership when it calculate its North Carolina taxable income

These changes are effective as of January 2022, and if the North Carolina Partnership has already filed its 2022 tax return, it can amend its 2022 tax return to make the 2022 PTE election, as long as it does so by the due date for filing its 2022 tax return, including extensions.

NCDOR April 4, 2023, Important Notice.

## VIII. Estimated Tax Payment Requirements.

For 2022, PTE's were not required to make estimated income tax payments throughout the 2022 tax year. In future tax years, a PTE that anticipates making the PTE election for a given tax year must only make estimated tax payments if the PTE had elected to be a PTE **for the prior taxable year.**

So, if the PTE makes a PTE election for 2022, then that PTE will have to make estimated tax payments for 2023 if the pass-through entity anticipates making the PTE election for 2023 as well.

Any overpayment by the PTE of its North Carolina estimated tax payments are refunded back to the PTE and not to the individual owners.

## IX. Specified Income Tax Payments.

In the IRS Notice 2020-75, you will see the phrase "specified income tax payment" (also referenced as "SITP") which generally refers to any amount of state income tax that a PTE pays directly to the state taxing authority.

The PTE will then deduct the SITP as a business expense on its federal income tax return.

The Notice goes on to state that the SITP will be reflected on a partner's or S corporation shareholder's K-1 as a distributive or pro rata share of non-separately stated income or loss.

## X. North Carolina Tax Treatment For the PTE.

The Important Notice outlines how the PTE calculates its North Carolina taxable income for purposes of paying the PTE tax.

The Notice states that the starting point would be the **sum** of:

(A) Each owner's share of the PTE's income or loss – subject to the decoupling adjustments under N.C.G.S. 105-153.6 - attributable North Carolina; **plus**

(B) Each resident owner's share of PTE income or loss – subject to the decoupling adjustments under N.C.G.S. 105-153.6 - not attributable to North Carolina.

The adjustments mentioned in Section 105-153.6 relate to the decoupling adjustments required under N.C.G.S. 105- 153.6.

The Important Notice further states that "separately stated" items of deduction are **not** included when calculating each owner's share of the PTE taxable income. Presumably, this means that a PTE could well overpay the PTE tax of its owners.

In addition, the adjustments required by Section 105-153.5(c3), dealing with the specific adjustments unique to PTEs, are not included in the calculation of the Taxed PTE's taxable income.

### A. Net Income

Once the PTE makes the PTE election and pays the North Carolina tax, the owners do not get taxed a second time for North Carolina tax purposes on their share of PTE income. Instead, their share of PTE income is deducted on the state return to the extent it was included in the Taxed PTE's North Carolina taxable income and the owner's adjusted gross income.

### B. <u>Net Losses</u>

Any losses by the electing PTE will not be deducted on the personal return and will not flow through. Instead, the loss will carry forward into future tax years of the PTE.

If the PTE has a net loss for the year, then each owner of the PTE must **add back** its share of the net loss to the owner's North Carolina tax return to the federal AGI on the North Carolina tax return.

If the pass-through entity expects to recognize a loss for 2023, then the loss would not be deductible to the owners of the PTE if the PTE election is made. So, in that case, if a loss is anticipated, the PTE may decide not to make the PTE election so that the losses can be available to be used by the owners (of course assuming they have sufficient tax basis to absorb the loss on their personal tax returns).

> **Note**: What about a PTE Partnership or S Corporation that undergoes an asset sale or a stock sale in 2023 which is either a loss year or a year in which the PTE overpays its North Carolina estimated tax? How will the owners of the selling S corporation or partnership get the benefit of the loss generated in 2023 or the excess North Carolina tax payments made in 2023?

## XI. Tax Treatment For PTE Owners.

The owner of the taxed PTE will deduct the amount of the owner's share of income from the taxed PTE to the extent it was included in the taxed PTE's **North Carolina taxable income** and the owner's federal AGI. Likewise, the owners of a PTE also will claim a deduction for income taxed at the PTE level by other states.

Note that even if the PTE makes the PTE election, the individual owners have to include on their North Carolina personal tax returns any "decoupling" add backs or subtractions set out in N.C.G.S. 105-153.6 that are otherwise included in the PTE's taxable income (such as bonus depreciation, deduction add backs, etc.) and thus included in the calculation of the North Carolina tax imposed on PTE's.

## XII. Non-North Carolina Residents.

If a shareholder or partner in a North Carolina PTE is not a resident of North Carolina, then they will not be required to file a separate tax return in North Carolina because their North Carolina tax obligations will have been met by the PTE entity itself. Note this may be another advantage to making the PTE election.

## XIII. Rental Enterprises and Investment Partnerships.

The November 2022 updates to the Important Notice advised that rental real estate pass-through entities are eligible to make the PTE election, but that investment partnerships are not eligible to make the PTE election, since investment partnerships are not deemed to be "doing business" in North Carolina, and thus are not required to file a North Carolina tax return. See NCDOR Important Notice April 4, 2023 and 17 N.C.A.C. 06B.3503(c). Also see Private Letter Ruling 2020-01 (January 31, 2020).

## XIV. Treatment of Tax Credits.

There has been a great deal of confusion as to how the credits themselves work. This is how we understand the rules to be:

### A. Tax Credits in General.

The NCDOR Important Notices advise that a North Carolina Taxed PTE cannot pass a North Carolina income tax credit to its owners (such as a tax credit for income taxes paid by the PTE to another state), and that a PTE cannot pass to its owners any carryforward of any unused portion of a tax credit that was claimed by the PTE on the PTE's North Carolina tax return.

### B. Treatment of Tax Credits for Multi-State Taxpayers.

(1) **A North Carolina PTE and a PTE in Other States.** Here, the PTE can claim a credit for income tax paid to other states to the extent that the income is allocable to North Carolina resident owners. The PTE qualifies for the credit and the credit is not passed through to the individual owners of the PTE and the owners themselves do not claim the PTE credit.

(2) **The PTE is a North Carolina PTE but it is not an electing PTE in the other state.** Here, the owner of the North Carolina PTE claims a credit for taxes paid to another state.

(3) **An S Corporation or Partnership that does not make the PTE election in North Carolina but does make the election in another state.** Here, only the owner of the PTE gets the North Carolina credit for taxes paid to the other state by the S corporation or partnership.

> **NOTE.** If an individual taxpayer is an owner of an out-of-state PTE and has already filed its 2022 income tax return, and under new SB 174 the North Carolina individual is eligible to claim a tax credit for taxes paid to another state, the owner can file an amended Form D-400 at any time within the general statute of limitations for claiming a refund. April 4, 2023 NCDOR Important Notice.

## XV. Special Problems and Case Studies.

1. Definition of "Qualifying" Owners.

2. Making the PTE Election for "Single Member" LLC's.

3. Reconciling Losses and Credits in Ownership Change Years. What about a PTE Partnership or PTE S Corporation that undergoes an asset sale or a stock sale in 2023 which is either a loss year or a year in which the PTE overpays its North Carolina estimated tax? How will the owners of the selling S corporation or partnership get the benefit of the loss generated in 2023 or the excess North Carolina tax payments made in 2023?

4. Investment Partnerships and Real Estate Enterprises.

5. Tax Treatment of Separately Stated Deductions (Capital Contributions, Section 179 Depreciation and Self-employed Retirement Contributions) May Result in Tax Overpayment.

6. Collateral Consequences of Federal State Tax Deduction: reduced passive income, reduced QBI deduction and reduced self-employment income.

7. Potential "Waste" of Passive Losses and/or Capital Losses At the Owner Level.

8. Possible Disparities Among PTE Owners in Different States.

9. Problems For PTEs Operating in Multiple States.

10. Section 704(b) "Special Allocations" of Federal State Tax Deductions.

11. Claiming the PTD Deduction on Form 1065-Deduction From Page 1 Ordinary Income vs. Schedule D. Reduction of Capital Gains.

12. Tiered PTE Structures.

## PART TEN
## WAYFAIR AND THE ECONOMIC PRESENCE TEST
## U.S. SUPREME COURT UPHOLDS "ECONOMIC PRESENCE" NEXUS TEST; SOUTH DAKOTA VS. WAYFAIR INC.

**A. Overview of Wayfair.** On June 21, 2018, the United States Supreme Court upheld the constitutionality of a South Dakota nexus statute which required that out-of-state remote sellers collect sales tax if it (1) made more than $100,000 in sales into the state of South Dakota or (2) engaged in at least 200 sales transactions with South Dakota residents, regardless of whether or not the remote seller actually had any physical presence in South Dakota and even if it had no assets or employees physically present in the State of South Dakota. [South Dakota vs. Wayfair, Inc., 138 S. Ct. 2080 (2018)].

In Wayfair, the Supreme Court overruled its earlier 1992 decision in Quill vs. North Dakota that established the "physical presence" requirement that required states to show that remote sellers have a physical presence in that state before for states could force the out-of-state retailers to collect sales tax. Before Wayfair, states were prohibited from forcing out-of-state retailers to collect sales tax on sales to in-state residents, unless the out-of-state seller had some "physical presence" in the taxing state, such as "brick and mortar" facilities or employees actually located in the taxing state. Effectively, Wayfair now substitutes an "economic presence" test for the "physical presence" nexus test previously in place under the Quill decision.

At the present time, many states have enacted, or are in the process of enacting, economic presence legislation very similar to the South Dakota legislation that was the subject of the Wayfair case.

**B. North Carolina Adopts The Economic Nexus Test.** During the 2018 summer legislative session, the North Carolina General Assembly did not adopt any new economic presence legislation. However, on August 7, 2018, the North Carolina Department of Revenue issued a Directive (S.D. 18-6) advising that, effective November 1, 2018, the NCDOR would require that remote out-of-state sellers, having gross sales in excess of $100,000 sourced in North Carolina or two hundred (200) or more separate transactions sourced in North Carolina in the previous or current year to register, collect and remit sales and use tax beginning November 1, 2018 or 60 days after the seller meets the threshold amount, whichever is later. Although the General Assembly did not adopt a specific statute which implemented the $100,000\200 transaction threshold requirement, the NCDOR stated that it believed that, under existing language in N.C.G.S. 105-164.8(b)(5) that it had the legislative authority to impose sales tax obligation collection obligations on remote sellers who met the $100,000\200 transaction test.

N.C.G.S. 105-165-8(b) provides in relevant part as follows:

> (b) Remote Sales – a retailer who makes a remote sale is engaged in business in this State and is subject to the tax levied under this Article if at least one of the following conditions is met:
>
> (5) The retailer, by purposefully or systematically exploiting the market provided by this State by any media-assisted, media-facilitated, or media-solicited means, including direct mail advertising, distribution of catalogs, computer-assisted shopping, television, radio or other electronic media, telephone solicitation, magazine or newspaper advertisements, or other media, creates nexus with this State. A nonresident retailer who purchases advertising to be delivered by television, by radio, in print, on the Internet, or by any other medium is not considered to be engaged in business in this State based solely on the purchase of the advertising.

### C. North Carolina's Remote Sales Statute.

N.C.G.S. 105-164.8(b)(9) was added to codify the SD-18-6 and the Wayfair decision. This subsection (b)(9) specifically provided that any retailer, with remote sales into North Carolina for the ***previous or current calendar year***, that had one or more of the following:

(a) gross sales in excess of $100,000; or

(b) 200 or more separate transactions

must register for, collect and remit sales tax.

So, this means that once a remote seller has met the threshold for the current year or a future year, it will then have 60 days from the date that it hits the threshold to register and begin collecting and remitting North Carolina sales tax on sales sourced to North Carolina.

Interestingly, in the Directive, the NCDOR mentions that, since North Carolina is a member of the Streamlined Sales and Use Tax Governing Board ("SSTGB"), remote sellers can register for all 24 streamline member states by submitting and completing one online application through the Streamlined Sales Tax Registration System ("SSTRS"). In addition, if an out-of-state seller registers through the SSTRS and then later needs assistance calculating tax or preparing returns in any of the streamline member states, the SSTGB has access to certified service providers who can assist the remote seller with its sales and use tax functions.

### D. NC Modifies "Economic Nexus" Threshold to Provide Relief for Some Out-of-State Remote Sellers.

Previously, the NCDOR issued its Directive SD-18-6 which adopted an "economic nexus" threshold requiring remote retailers to register for sales tax collections in North Carolina if, in the current or previous year, they had more than $100,000 of sales in North Carolina or at

least 200 separate transactions. In 2019, North Carolina's "economic nexus" threshold standard was codified in newly adopted N.C.G.S. 105-164.8(B)(9).

In an effort to provide relief to certain out-of-state small businesses making remote sales into North Carolina, the more than "two hundred transaction" threshold has been dropped from the North Carolina economic Nexus threshold requirement. N.C.G.S. 105-164.8(b)(9) and (10).

Now, an out-of-state remote seller with no physical presence in NC, that makes less than $100,000 in gross sales into North Carolina for the current or previous year can avoid sales tax economic nexus regardless of the number of transactions with North Carolina customers. This change is effective July 1, 2024.

### E. 2020 Changes to the Sales Tax Rules for Marketplace Facilitators.

N.C.G.S. 105-164.4J has been revised to delete the $100,000/200 transaction safe harbor for marketplace facilitators and now, regardless of the level of sales, any marketplace facilitator that is "engaged in business in North Carolina" will be treated as the retailer of a sale and must collect and remit the applicable North Carolina sales tax.

This means that marketplace facilitators operating outside of North Carolina will have to collect and remit sales tax from all of the sales even if they do not exceed $100,000/200 to a transaction threshold. This means that marketplace facilitators like Etsy and Ebay no longer receive the $100,000/200 transaction safe harbor available to other remote sellers.

# PART ELEVEN
# NORTH CAROLINA SALES AND USE TAX DEVELOPMENTS

## I. New Statute of Limitations on Assessment of Refunded Sales Taxes.

Under House Bill 228 (SL 2024-28), if a retailer collects a sales tax on a transaction and later refunds that sales tax to the purchaser, the NCDOR may now assess the sales tax to the purchaser within three years of the date of the refund. N.C.G.S. 105-241.8(b)(5).

This change is effective for assessments arising after July 1, 2024, for assessments for which the statute of limitations had not already expired.

## II. New Time Limits For Obtaining an Affidavit of Capital Improvement.

Persons providing services with respect to real property may rely on Affidavit of Capital Improvement issued by the property owner or contractor to avoid having to charge sales tax on those services. N.C.G.S. 105-164.4H(a1).

House Bill 228 (S.L. 2024-28) now provides that, to substantiate the exemption from collecting sales tax on capital improvements to real property, a service provider must obtain the Affidavit of Capital Improvement within 90 days of the service sale **or** within 120 days of a request by the NCDOR. S.L. 2024-28, Sec. 2.5; N.C.G.S. 105-164.4H(a1).

This change is effective July 1, 2024.

## III. NCDOR Issues "Important Notice" For Real Property Contractors to Certify Payment of Sales and Use Tax; August 5, 2024.

A. **Background.** Under N.C.G.S. 105-164.4H(a), a real property subcontractor normally must pay sales and use tax on the sales price of materials it purchases to perform a real property contract. For example, if a general contractor hires a subcontractor to purchase and install cabinets in a new home, the subcontractor must pay sales and use tax on the sales price of cabinets and hardware it purchases to perform the real property contract for the homebuilder. Importantly, under N.C.G.S. 105-164.6(b), if the subcontractor (the cabinet installer in our case) fails to pay sales tax on its hardware and cabinet purchases, then the following people are ***jointly and severally liable*** for sales tax the cabinet installer failed to pay:

the real property owner;
the lessee;
the real property contractor; and
the subcontractor.

So, the NCDOR could technically hold all the aforementioned parties, in addition to the cabinet installer, jointly and severally liable for the sales tax the cabinet installer failed to pay. However, North Carolina law also provides that the real property owner and the real property contractor, who do not directly purchase an item that becomes part of real property, is relieved of

use tax liability if they can secure an affidavit from the purchaser\subcontractor certifying that sales tax been paid. N.C.G.S. 105-164.6(b). However, prior to August 5, 2024 there was no prescribed form of affidavit for real property contractors to use.

**B. New Form E589P, Affidavit of Tax Paid by Real Property Contractor**. On August 5, 2024, the NCDOR issued a new Important Notice which now makes available a new affidavit, Form E589P, Affidavit of Tax Paid by Real Property Contractor, to be used by real property contractors. The purpose of this new form is to provide real property contractors and property owners with an affidavit it may rely upon to substantiate that a contractor has paid sales and use tax on the materials it purchases and affixes to real property as part of the real property contract.

Under the new notice, a properly completed form E589P will relieve real property owners, lessees, general contractors and property owners from joint and several use tax liability when they did not purchase the items covered by the affidavit. The Important Notice warns the real property owner, lessee or general contractor should request a Form E589P from a real property contractor who purchases materials that become a part of real property.

The Important Notice also provides a "comparison and contrast" analysis of the differences between Form E589P and Form E589CI, Affidavit of Capital Improvement, and when those forms are used during the course of a real property contract.

## IV. North Carolina Supreme Court Rules North Carolina Statute Does Not Violate Commerce Clause of the U.S. Constitution; Quad Graphics, Inc. vs. North Carolina Department of Revenue, 881 S.E.2d 810 (April 12, 2023).

Quad Graphics, an S Corporation headquartered in Wisconsin, was engaged in the production and sale of printed materials, including books, magazines, catalogs and other items for distribution across the United States.

Between 2009 and 2011, Quad Graphics accepted around $20 Million of orders for delivery of its product to customers or third-party recipients located in North Carolina.

Quad Graphics shipped all of its products via US Postal Service or via common carrier for delivery to its customers inside North Carolina. However, according to the Quad Graphics' sales contracts, legal title and risk of loss for any ordered materials passed from Quad Graphics to its customers "FOB" shipping point, which meant that legal title and all "risk of loss" passed from Quad Graphics once it delivered those materials to common carriers outside of North Carolina.

During part of the periods at issue (from September 2009 through the end of 2011), Quad Graphics employed a sales agent in North Carolina to solicit sales orders and to service customer accounts inside North Carolina. Quad Graphics maintained no physical facilities in North Carolina.

The NCDOR took the position that Quad Graphics should have collected and remitted sales tax on its sales to North Carolina residents from 2007 through 2011 based upon the North Carolina "sourcing statutes" of N.C.G.S. 105-164.4B(a)(2). Later, the NCDOR conceded that Quad Graphics was not responsible for collecting and remitting sales tax on sales to North Carolina customers during the period before September 2009 since, until that time, Quad Graphics did not maintain any employees or physical presence within North Carolina.

The critical statute at issue here was North Carolina's "destination based" sourcing statute found in N.C.G.S. 105-164.4B(a)(2) which provides that, when a purchaser receives a product at a location specified by the purchaser, the sale is "sourced" to the location where the purchaser receives the product. And, in the case of direct mail, direct mail is "sourced" to the location where the product is delivered when the purchaser provides the seller with information indicating where the direct mail is to be delivered.

Quad Graphics argued that, since risk of loss and legal title to its goods passed to North Carolina's customers outside of North Carolina by virtue of delivery to a common carrier "free on board" in another state, N.C.G.S. 105-164.4B(a)(2) violated the Commerce Clause of the United States Constitution.

Quad Graphics argued that North Carolina's destination sourcing statute was unconstitutional since it would permit the NCDOR to tax a transaction occurring outside of North Carolina by virtue of the fact that title and risk of loss passed to common carriers outside the state.

In ruling in favor of Quad Graphics, the Business Court held that Quad Graphics' activities lacked sufficient nexus to North Carolina for imposition of state sales tax under the Commerce Clause.

However, on direct appeal to the North Carolina Supreme Court, the North Carolina Supreme Court reversed the Business Court and held that the destination base sourcing rule in North Carolina did not violate the Commerce Clause, notwithstanding that title to Quad Graphics products passed to its customers outside the State of North Carolina.

> **<u>Note:</u>** Recently, the United States Supreme Court refused to review the North Carolina Supreme Court's Quad Graphics' decision. Cert. Denied, U.S.S.Ct., Dkt. No. 22-890 (June 20, 2023).

## V. <u>NC Department of Revenue vs. FSC II, LLC, 22 CVS 5410 (2023 NCBC 9) January 30, 2023</u>

The question in the FSC case was whether FSC could qualify for a reduced tax use rate on equipment that FSC, a road construction company, purchased out-of-state to manufacture asphalt the taxpayer/contractor used in its road construction contracts.

FSC was engaged in public infrastructure construction and commercial site work construction in North Carolina. During the relevant tax years, FSC operated four facilities in

North Carolina that produced hot mix asphalt ("HMA"). During the 2012, 2013 and 2014 tax years, FSC used approximately 80% of the HMA it manufactured to perform its highway construction contracts. FSC claimed that it qualified as a "manufacturer" for purposes of their applicable reduced use tax rate for mill machinery under former NCGS 105-187.51 which was in effect at that time.

Under the old mill machinery use tax exception, the maximum use tax was $80 per article on each item of mill machinery or mill machinery parts and accessories purchased by a "manufacturing industry or plant". FSC argued that its out-of-state purchases of tools, parts and equipment for HMA production in North Carolina were eligible for the lower $80 per article tax on mill machinery parts and accessories.

FSC contended that it qualified as a "manufacturer" for purposes of the mill machinery exemption and therefore it was liable only for the lower privilege tax on the tools and equipment it purchased out-of-state rather than the higher sales or use tax.

The NCDOR, however, took the position that the tools, parts and equipment were not subject to the mill machinery exemption. The NCDOR took the position that FSC was "primarily" engaged in the construction of public infrastructure projects and that it used the majority of the HMA that it produced to complete those road projects. Therefore, according to the DOR, FSC could not be deemed to be a "manufacturing industry or plant" because at all times it was acting as a contractor rather than as a "manufacturer." Thus, the critical issue for the Business Court was whether FSC qualified as a "manufacturing industry or plant".

The DOR conceded that FSC's process of producing HMA, using its purchased parts and equipment, was consistent with the generic definition of "manufacturing". However, the DOR took the position that FSC's production of HMA alone was not enough to transform FSC into a "manufacturing industry or plant" for purposes of the mill machinery exemption. According to the NCDOR, FSC must <u>also</u> establish that it was "primarily" or "principally" engaged in the sale of HMA that it produced in order to qualify for the exemption.

The North Carolina Supreme Court recently affirmed the North Carolina Business Court and the Office of Administrative Hearing's grant of summary judgment in favor of FSC. NC Department of Revenue vs. FSC II, LLC, 150A23, slip opinion (NC May 23, 2024).

The Business Court had ruled that there was no statutory language in NCGS 105-187.51 that required that a taxpayer be engaged "primarily" or "principally" in the business of selling manufactured products to a third party in order to be eligible for the mill machinery exemption. The court noted that, in other sections of the North Carolina tax statutes, the North Carolina General Assembly has expressly added, to statutory text, language such as "principal" or "primary" that the NCDOR claim should be implied to exist in NCGS 105-187.

Here in this case, FSC clearly "manufactured" its HMA by meeting the judicially created definition of "manufacturing", which is defined as "producing a new article or use or ornament by the application of skill and labor to the raw materials of which it is composed." <u>Duke Power Company v. Clayton</u>, 274 N.C. 505, 164 S.E.2d 289 (1968).

Interestingly, the court refused to conclude that FSC still would have qualified for the mill machinery exemption if it had used 100% of its HMA for its own contracts. FSC contended that, even if it did not sell any of its HMA to outside third parties, it could still qualify for the mill machinery exemption. The court, however, declined to expand its ruling so broadly and instead simply stated that the volume of HMA sold to outside third parties was not "insignificant".

## VI. Taxable Property Management Services Under Senate Bill 523 (2019).

Section N.C.G.S. 105-164.4K was added to provide that repair, maintenance and installation services provided by a "real property manager" under a "property management contract" are subject to sales and use tax in the following circumstances:

1. Where the RMI services are provided by the real property manager for an additional charge.

2. Where the real property manager arranges for a third-party to provide the RMI services and the real property manager charges an additional contract amount or charge for arranging for these services; or

3. Where more than 25% of the time spent managing the real property for a certain billing period is attributable to repair, maintenance and installation services. If this section (3) applies, then sales taxes are owed on the sales price or gross receipts attributable to the repair, maintenance and installation services portion of the property management contract, and it is the responsibility of the real property manager to determine an allocated sales price for the repair, maintenance and installation services portion of the property management contract based on a reasonable allocation of revenue that is supported by business records kept in the ordinary course of business. The charges for the taxable repair, maintenance and installation services must be separately stated on the invoice at the time of the sale.

Note that new N.C.G.S. 105-164.4K only applies to "property management contracts" involving a "real property manager". A real property management contract is a written contract which obligates a person to provide five (5) or more real property management services. N.C.G.S. 105-164.3(30)(b). N.C.G.S. 105-164.3 (33f.1) sets forth the definition of "real property management services" as follows:

a. Hiring and supervising employees for the real property.

b. Providing a person to manage the real property.

c. Receiving and applying revenues received from property owners or tenants of the real property.

d. Providing repair, maintenance, and installation services to comply with obligations of a

home-owners' association or a landlord under a lease, rental, or management agreement.

e. Arranging for a third party to provide repair, maintenance, and installation services.

f. Incurring and paying expenses for the management, repair, and maintenance of the real property.

g. Handling administrative affairs for the real property.

**Effective Date**. This new Section 105-164.4K became effective as of July 26, 2019.

**Grace Period**. Fortunately, however, if a real property manager fails to collect sales tax on repair, maintenance and installation services that are otherwise taxable under 105-164.4K, then the Department of Revenue shall not assess liability for failure to collect from January 1, 2019, up through January 1, 2021.

## VII. The RMI and Real Property Capital Improvement Matrix.

On April 18, 2018, the North Carolina Department of Revenue issued Directive SD-18-1 to address a number of issues relative to the application of repair, maintenance and installation services to real property. This Directive includes a "matrix" as to when various types of services or products will be taxable RMI services, versus non-taxable capital improvements. This Directive includes eighteen (18) pages of examples of specific items and services and when those various types of services or products will be taxable RMI services, versus non-taxable capital improvements.

Also, see N.C. Sales and Use Tax Division Form E-505 (September 17, 2017) which summarizes many of the changes brought by Senate Bill 628.

In addition, the 2018 Appropriations Act added three (3) new covered transactions to expand the list of transactions that can possibly be subject to amnesty. A new subsection 8(a) was added for taxpayers who failed to collect sales tax on a mixed transaction contract that exceeded 25% and a new 8(b) was added for taxpayers who failed to collect sales tax on the taxable portion of a bundled transaction. In addition, more importantly, a new subsection (10) was added to provide for potential amnesty for a taxpayer who failed to collect sales tax on repair, maintenance and installation services for tangible personal property, motor vehicles or digital property.

## VIII. Alternative Sales Tax Compliance Option for Certain RMI Services.

Section 2.8 of Senate Bill 628 (2017) provides an optional method for RMI service providers to comply with new sales tax rules. Under this Section 2.8, if a RMI service provider can prove that it paid sales or use tax on the purchase of tangible property used to perform a RMI service, then the RMI service provider can claim a credit against the sales tax chargeable on the RMI service equal to the amount of sales and use tax paid by the RMI service provider when purchasing tangible personal property to perform the RMI service.

This offset provision was scheduled to expire on July 1, 2018. However, the 2018 Appropriations Act makes this offset option fix permanent.

## PART TWELVE
## CORPORATE INCOME AND FRANCHISE TAX DEVELOPMENTS.

### I. Corporate Income Tax Reductions.

SB 257 (2017) revised N.C.G.S. 105-130.3 to provide that the corporate income tax rate would be reduced from 3% to 2.5%, **beginning in 2019**. SB105 further reduces the corporate tax rates, beginning in 2021, as follows:

| Tax Year | Tax Rate |
|---|---|
| 2021 | 2.5% |
| 2022 | 2.5% |
| 2023 | 2.5% |
| 2024 | 2.5% |
| 2025 | 2.5% |
| 2026 | 2% |
| 2027 | 2% |
| 2028 | 1% |
| 2029 | 1% |
| 2030 | 0% |

### II. Franchise Tax Changes.

Before 2023, the North Carolina corporate franchise tax was determined based on the greater of the following three factors: (1) the corporation's "net worth" as determined under GAAP; (2) the "book value" of its North Carolina real and tangible personal property (minus any debt on the real property); and (3) 55% of the corporation's "appraised value" of its North Carolina real and tangible personal property. Under Senate Bill 105, going forward, the North Carolina franchise tax will be determined solely based upon the corporation's "net worth" as determined under GAAP. This change is effective for franchise taxes due for 2023 as reported on the 2022 corporate income tax return.

### III. House Bill 259 (Session Law 2023-134) Caps the Franchise Tax.

House Bill 259 (October 3, 2023) caps the franchise tax rate at $500 for the first $1 Million of a C corporation's tax base. After that, the existing rate of $1.50 per $1,000 of its tax base applies up to a **maximum tax due of $150,000.**

This change becomes effective on January 1, 2025, and applies to the franchise tax calculation on the 2024 corporate income tax return.

## IV. The Reintroduction of the Real Property Conservation Credit.

Before 2017, North Carolina corporate and individual income tax rules provided for a nonrefundable income tax credit for certain real property donations for conservation purposes. However, the real property conservation credit was repealed for tax years beginning in 2016.

Senate Bill 355 (S.L. 2024-32) has resurrected the real property conservation credit for two (2) years. The amount of the credit is equal to 25% of the fair market of value real property located in North Carolina and donated for conservation purposes. The amount of the credit is capped at $200,000 for individual taxpayers and $500,000 for corporations.

However, the new rule little slightly modifies the property eligibility requirements that are different now than under the pre-2013 law. N.C.G.S. 105-130.34 and 105-153.11.

Also, the maximum amount of credits allowed in a year to all qualifying taxpayers is limited to $5 million, which means that the credits will be prorated for credit applications that exceed $5 million in total.

## V. Exclusion for Amounts Received for Economic Incentives.

Session Law 2019-237 (November 1, 2019) added a new subsection (31) to N.C.G.S. 105-130.5(b), to now allow corporations to deduct from federal taxable income, to the extent included in federal taxable income, amounts received by a taxpayer as an economic incentive pursuant to N.C.G.S. 143B-437.012 or Part 2G or Part 2H of Article 10 of Chapter 143.

## VI. 2020 Provisions Effecting Businesses; Net Business Interest Deduction.

The Cares Act increased the amount of adjusted taxable income that may be offset by net business interest for 2019-2020, from 30% to 50% of taxable income.

Under the Cares Act, the limitation on the amount of taxable income that may be offset by net business interest was increased from 30% to 50% for 2019 and 2020.

However, Session House Bill 1080 requires both corporate and individual taxpayers to "add back" the additional interest expense deduction. N.C.G.S. 105-130 5(a)(31).

## VII. HB 97 (2015) Moves To a Steady Phase-In of Single Sales Factor Apportionment.

HB 97 provided that, beginning in 2016, the appointment factor for multi-state corporations would gradually move from a "multi-factor" approach to a single sales-factor approach.

For 2016 and 2017, multi-state tax apportionment was made based on the property factor, the payroll factor and the sales tax factor, but for 2016 and 2017, the sales tax factor was given

more weight until 2018, when the property factor and the payroll factor were completely removed.

Thus, for 2018 and beyond, the apportionment statute will rely solely on "sales sourcing" rules. See revised N.C.G.S. 105-130.4(i).

## VIII. Apportionment: North Carolina Adopts Market-Based Sourcing

Session Law 2019-246 amended N.C.G.S. 105-130.4(l) to adopt market-based sourcing for apportioning the corporate income tax and franchise tax, effective for taxable years beginning on or after January 1, 2020. Under market-based sourcing, receipts will be sourced to North Carolina if North Carolina is the location of the taxpayer's market for receipts. If the market for a receipt cannot be determined, the receipts will be sourced inside or outside of North Carolina based upon a "method of reasonable approximation." If the source of a receipt cannot be reasonably approximated, the receipt must be excluded from the denominator of the apportionment fraction.

For sales of tangible personal property, North Carolina has always had sourcing rules that source receipts to the state where tangible personal property is delivered. Until the new changes, receipts from services were sourced by reference to where the activities that produce the service income take place. Under the new market-based sourcing rules, service receipts will be sourced to the place where the services are delivered. New N.C.G.S. 105-130/4(l)(4).

## IX. NCDOR Issues Notice on Computing the Sales Factor Based on Market Based Sourcing.

In November 2019, Senate Bill 557 (SL 209-246) enacted market based sourcing for state income tax apportionment. Previously, the Department of Revenue adopted administrative rules for market-based principals and these rules apply to tax years beginning on or after January 1, 2020.

Under the new law, services are "sourced" to North Carolina if and to the extent the service is delivered to a location in North Carolina. In the case of tangible personal property, the sourcing of receipts from the sale of tangible personal property remains based upon the property being received in North Carolina by the purchaser.

The Corporate Tax Division of NCDOR has issued a "Summary for Computing the Sales Factor Based on Marked-Based Sourcing". This summary can be found at the NCDOR website. The NCDOR's summary contains six pages of charts describing in precise detail when a service or sale of tangible personal property will be sourced into North Carolina.

## X. <u>North Carolina Important Notice: Impact of Market Based Sourcing on Pre-2020 Private Letter Rulings (February 1, 2020).</u>

The Department of Revenue has reminded us that, now that we have moved to a "market-based" sourcing system, with a single sales factor for apportioning and allocating income of multi-state corporations between North Carolina and other states, we should no longer rely on old Private Letter Rulings issued before January 1, 2020, because those old Private Letter Rulings were based on a multi-factor apportionment regime.

## XI. <u>Corporate Tax Changes to the Definition of "Apportionable" Income.</u>

Previously, N.C.G.S. 105-130.4(a)(1) defined "apportionable income" as all income that is "apportionable under the United States Constitution." Senate Bill 628 enacted an amendment to the definition of "apportionable income" in N.C.G.S. 105-130.4(a)(1) to provide that apportionable income is to be defined as all income apportionable under the United States Constitution, "including income that arises from" the following specified items:

1. Transactions and activities conducted in the regular course of the taxpayer's trade or business; and

2. Tangible and intangible property if the acquisition, management, employment, development or disposition of the property is or was related to the operation of the taxpayer's trade or business.

This change is effective immediately.

**<u>Note</u>:** Presumably, this new language was intended to provide further support to the North Carolina Department of Revenue's ongoing interpretation of the definition of "apportionable income."

# PART THIRTEEN
# PARTNERSHIPS AND S CORPORATIONS

## I. Non-Resident Affidavit Requirements in Lieu of Composite Returns.

North Carolina law provides generally that managers of a pass-through business, with one or more non-resident owners, must file a composite return with North Carolina and pay the non-resident owner's share of the North Carolina tax.

However, under current North Carolina law, if the non-resident owner is a business (and not an individual), then there is no composite return required if the N.C. business furnishes an affidavit to the NCDOR signaling non-resident business confirming that the non-resident business will pay its own North Carolina tax with its own North Carolina filed tax return.

House Bill 1080 codifies the NCDOR's position that this affidavit must be filed every year by the due date of the North Carolina pass-thru entity return. N.C.G.S. 105-154(d).

## II. Partnership With Non-resident Partners Must Still File North Carolina Tax Return, Private Letter Ruling 2020-01 (January 31, 2020).

In this PLR, the Department of Revenue clarified that a partnership (owned by one North Carolina resident and five non-residents) would be deemed to be "doing business" in North Carolina and would not qualify for the North Carolina partnership return filing exemption of Administrative Rule 17 N.C.A.C. 06B.3503(c), and therefore required to file a North Carolina partnership tax return in North Carolina, if it engaged in the operation of any activity in North Carolina for economic gain, including owning or renting realty. In this letter ruling, the partnership was not engaged in any type of ongoing business in North Carolina, but instead simply held and sold some real estate that was located in North Carolina. The Department of Revenue ruled that "doing business" in North Carolina included merely holding real property and that the partnership would be required to file a North Carolina partnership tax return and then withhold and remit any tax on a non-resident partner's distributive share of income from business operations in North Carolina.

## PART FOURTEEN
## OFFICE OF ADMINISTRATIVE HEARINGS DECISIONS

### I. McCabe v. North Carolina Department of Revenue, Office of Administrative Hearings, 19 REV 06681 (March 30, 2021).

In McCabe, the NCDOR questioned:

(1) whether the McCabes purchased renewable energy tax credits contrary to North Carolina law,

(2) whether the McCabes were bona fide partners under Federal law,

(3) whether the McCabe's transaction with a partnership should be characterized as "disguised sale" under Section 707 of the Internal Revenue Code, and

(4) whether certain allocations of tax credits, pursuant to the terms of a partnership agreement, met the "substantial economic effect" test under Section 704 of the Internal Revenue Code.

The OAH ruled against the McCabes. The McCabes then appealed that decision to the Business Court. The Business Court reversed the decision of the OAH and ruled in favor of the McCabes. (Wake County, 21 CVS 5724, April 6, 2023)

**Note**: The NCDOR appealed the Busines Court's decision in favor of the McCabes. However, in 2024, NCDOR withdrew its appeal. Final Decision on Remand (June 13, 2024).

**Note: Private Letter Ruling February 24, 2014.** The NCDOR rules that tax credits under N.C.G.S. 105-129.16A, that are allocated to partners of a partnership, may be applied against their North Carolina tax liability regardless of whether the taxpayers "materially participate" in the activity within the meaning of Section 469 of the Internal Revenue Code. The NCDOR determined that tax credits for investing in NC renewable energy property under old N.C.G.S. 105-129.16A is not contingent on any provision of the federal income tax law related to "passive activities" under Section 469 the Internal Revenue Code, and therefore North Carolina renewable energy tax credits would not be disallowed for North Carolina income tax purposes regardless of whether the taxpayer's investment was "passive" or "non-passive".

## II. State Law, and Not Federal Internal Revenue Code Statutes, Determines Whether a Taxpayer is a Bona Fide "Partner" in a Partnership, and Whether Transactions Between a North Carolina Partnership and Partner are "Disguised Sales"; Integon National Insurance Company vs. NCDOR, 20 REV 01001 (October 12, 2023).

Integon claimed North Carolina renewable property investment tax credits for its investment in Rockwood Capital V partnership.

Presumably from the OAH ruling, the NCDOR had argued that Integon wasn't a true "partner" of Rockwood, or that it engaged in some type of "disguised sale" transaction that would have made Integon ineligible for claiming NC renewable investment tax credits.

In reliance upon the North Carolina Supreme Court's decision in Fidelity Bank vs. NCDOR (370 NC 10) (June 13, 2017), 803 SE 2d 142, the OAH determined, by virtue of the record before it, that Integon had made capital contributions to Rockwood V, and that the organizational documents and partnership tax returns reflected Integon's status as a partner of Rockwood V thus entitling it to NC renewable investment tax credits.

In Fidelity Bank, the North Carolina Supreme Court held that, where the North Carolina tax statutes do not expressly incorporate specific Internal Revenue Code provisions for use in determining a taxpayer's obligation to pay North Carolina taxes, the court must construe the North Carolina tax statutes based on their clear meaning and not based on any definitions or defined terms contained in the Internal Revenue Code.

## III. Department of Revenue Directive TA-18-1 Explains North Carolina's Version of the "Mail Box" Rule.

This Directive (from August 2018), explains how North Carolina has adopted a modified version of the federal "Mail Box Rule" under Section 7502 of the Internal Revenue Code. This Directive states that an "otherwise late" tax return or "other document" is deemed to be timely filed or timely paid **only** when the document is **actually delivered** to the NCDOR, albeit after its due date, in which case the document will be deemed to have been received by the NCDOR on the date of the postmark stamped on the envelope in which it was mailed or the date of registration if delivered by registered or certified mail. According to the Directive, a "other document" includes an original return, an amended return, an informational report, a tax payment, a claim for tax refund and a Request for Departmental Review of a Notice of Assessment.

## IV. Timely Filing A Petition Before the Office of Administrative Hearing (OAH) To Challenge a Notice of Final Determination; All Medical Personnel, Inc. v. NC Department of Revenue (19 Rev. 06371 (August 28, 2020),

In **All Medical,** the taxpayer received a Notice of Final Determination ("NFD") from the NCDOR upholding a proposed assessment of tax on September 18, 2019. To contest the NFD, the taxpayer was required to file a Petition with the Office of Administrative Hearings within sixty (60) days, or by November 18, 2019, to seek OAH review.

The taxpayer timely mailed a Petition on **October 1, 2019** to the "State's Mail Service Center". [Unfortunately, the record does not show exactly to what address the OAH petition was mailed.]

On November 20, 2019, the taxpayer contacted the OAH to inquire upon the status of its Petition. The Deputy Clerk of the OAH advised the taxpayer that it had not received any Petition. The taxpayer then emailed a copy of the Petition to the OAH which the clerk accepted and filed that day.

However, the NCDOR then filed a Motion to Dismiss by virtue of the taxpayer's failure to timely file its Petition with the OAH. The OAH ruled against the taxpayer and held that, merely mailing the Petition out does the taxpayer no good. The Petition has to be received **and** accepted by the Clerk within the sixty (60) day period.

So here, the Petition was not "filed" with the OAH until November 20, 2019. Under 26 North Carolina Admin Code 3.0102(a)(2) the word "filing" means to "place the item to be filed into the care and custody of the chief hearings clerk of the [OAH], and **acceptance** thereof by the clerk". Thus, the Petition wasn't filed with the OAH until November 20, 2019, and thereafter the Petition was untimely.

Note again that here, there is no "mail box rule" and the mere receipt of mail by the NCDOR Service Center does not constitute a "filing" with the OAH.

## V. Another Petition Filed Late With The OAH: Billy Robertson vs. North Carolina Department of Revenue, 22 REV 00978 (May 17, 2022).

On January 11, 2022, the NCDOR issued a Notice of Final Determination ("NFD") to Mr. and Mrs. Robertson assessing additional income taxes. The NFD advised Mr. and Mrs. Robertson that they had the right to file a Petition within sixty (60) days from the date the NFD was mailed to Mr. and Mrs. Robertson.

Evidence indicated that the NFD was mailed out by the NCDOR on January 11, 2022, the same day it was issued, which meant that sixty (60) days from that date (March 14, 2022) would be the official due date for submitting a Petition before the OAH.

Mr. and Mrs. Robertson mailed out their Petition on March 12, 2022, and the OAH received and "file stamped" the Petition on March 15, 2022. And, even though the OAH

received and "file stamped" the Petition on March 15, 2022, the OAH Clerk did not "accept" the petition until March 30, 2022. By that date, the Petition was late and therefore the Department of Revenue filed a motion to dismiss the Petition.

In upholding the NCDOR's Motion to Dismiss, the OAH determined that the sixty (60) day time limit has no flexibility. Based upon various past court decisions and relevant administrative code provisions, a Petition is not "filed" until it is placed in the "care and custody" of the OAH Chief Clerk and the Chief Clerk "accepts" the petition. 26 N.C.A.C. 03 .0102; Grummels v. N.C. Dep't of Hum. Res., 98 N.C. App. 675, 678, 392 S.E.2d 113, 114-15 (1990).

Therefore, Mr. Robertson's Petition was filed too late.

## VI. Two Months is Not the Same as Sixty Days; Russell vs. NCDOR, 19 REV 662 (March 5, 2020).

Here, the NCDOR sent a Notice of Final Determination to Mr. and Mrs. Russell via letter dated October 4, 2019 (a Friday). An employee of the NCDOR actually testified that the Notice was indeed mailed to Mr. and Mrs. Russell on that same date.

Sixty days from the from the date on which the notice was mailed was Tuesday, December 3, 2019. The next day, on Wednesday, December 4, 2019, Mr. and Mrs. Russell filed a Petition for Contested Case Hearing before the AOH that was accepted and filed that same day.

The OAH dismissed the Petition since it was received a day late.

## VII. Petition Rejected Where It Was Filed By An Enrolled Agent; Burt Cox and Myra White vs. NCDOR, 19 REV 06234 (April 8, 2020).

Mr. Cox and Ms. White filed a claim for refund with the NCDOR. The NCDOR issued its final notice denying the refund claim as being outside the statute limitations for obtaining a refund. Then, a timely filed petition was filed claiming that the NCDOR acted erroneously in denying the refund claim. The petition, however, was not signed by Mr. Cox or Mrs. White, but instead was signed by a "Janine Skariot" who apparently was not a licensed attorney to practice law in North Carolina. Accordingly, the AOH dismissed the taxpayer's petition (even though it looks like the signor of the Petition was indeed an enrolled agent).

## VIII. Taxpayers Get Their Case Tossed Out For Not Paying Their Filing Fees.

Over the last several years, we have seen a number of taxpayers who filed a Petition for a Contested Case Hearing in the Office of Administrative Hearings, but had their Petitions tossed out for failing to pay a $20 filing fee. See Sprague vs. NCDOR, 19 REV 05618 (January 10, 2020), and Foster vs. NCDOR, 20 REV 02384 (August 21, 2020).

## IX. Petitions Dismissed for Insufficient Pleadings.

**A. Montague vs. NCDOR, 19 REV 05675 (March 5, 2020)** Mr. Montague applied for a tax refund for his alleged over paid taxes. The NCDOR sent Mr. Montague a Notice of Denial of the refund claim based upon the expiration of the statute of limitations. Mr. Montague then timely filed a Petition for a Contested Case before the OAH. The Petition came in the form of a one sentence letter that read "I am filing a petition for a contested tax case hearing in accordance with Chapter 150(b), Article 3 of the North Carolina General Statutes, regarding notice number: 5028-764-190-829".

The Notice referenced in Mr. Montague's Petition was a Notice he had received from the NCDOR denying his refund request based on the statute of limitations expiration. The OAH dismissed Mr. Montague's Petition on the basis that the Petition "failed to allege any agency error" and for not stating facts "tending to show the agency violated one or more provisions of the North Carolina Administrative Procedure Act."

This result seems fairly harsh considering that Mr. Montague represented himself "pro se". And besides, what did the AOH ***think*** that Mr. Montague was complaining about?

**B. Gatewood vs. NCDOR, 20 REV 03500 (November 17, 2020).** Mr. Gatewood filed a claim for refund which was denied by the NCDOR for falling outside the statue limitations for claiming a refund. The NCDOR subsequently issued a Final Notice to Mr. Gatewood. Mr. Gatewood then timely filed a Petition for a Contested Tax Case before the OAH and stated in his Petition as follows:

> I disagree with the determination to deny my request for a refund for the year 2015 tax return. I would like to file a petition for a contested tax case hearing in accordance with Chapter 150B, Article 3 of the North Carolina statutes. I have provided NCDOR the proper documentation to process my 2015 income tax return and I feel payment should be issued to me ASAP. I paid in taxes and I feel I am entitled to a refund.

The OAH then dismissed the Petition saying that Mr. Gatewood "failed to allege facts tending to establish that the Department committed any wrongful act, much less that it acted in violation of... of the general statutes... other than expressing his belief that he is entitled to the requested refund simply because he paid taxes. [Mr. Gatewood] does not allege that the 2015 refund claim was timely, nor denied that it was filed outside the statute of limitations, "...The failure of Petitioner to assert facts tending to show agency error renders the petition fatally defective and, thus subject to dismissal".

## X. Taxpayer Saved From Statute of Limitations Violation Where NCDOR Had Opened an Audit.

In Bass v. North Carolina Department of Revenue, Office of Administrative Hearings, 16 REV 10369 (May 26, 2017), Mr. Bass had attempted to electronically file his 2012 tax return showing that he was entitled to a refund for that year. Mr. Bass never followed up from the NCDOR to inquire as to the status of his refund.

The NCDOR had evidence of income that Mr. Bass received for 2012 although the NCDOR had never received a tax return. At the request of NCDOR, Mr. Bass then submitted additional information to the NCDOR showing that he was entitled to a refund of 2012 tax overpayments.

The NCDOR then issued a Denial of his refund request because the refund request was submitted after the expiration of the statute for limitation for filing a refund claim. Nevertheless, the Administrative Office of Hearings determined that, when a taxpayer provides requested additional information to the NCDOR within the statute of limitations for claiming a refund, the refund request must not be denied.

## XI. When Does the Twenty-Five (25%) Percent Large Payment Penalty Apply? NCDOR v. Greta Clifton, 21 CVS 11892, 2022 NCBC 20 (April 28, 2022).

After Ms. Clifton's 2015 tax return was filed, the Department of Revenue disallowed all of her business expenses that she had claimed on Schedule C of her 2015 Federal Tax Return. As a result, Ms. Clifton's federal AGI was increased from $14,000 to $40,000, which represented an increase of roughly 64%.

The NCDOR assessed a Large Individual Income Tax Deficiency Penalty of $371 pursuant to N.C.G.S. 105-236(a)(5)(b) for understating her income by 25% or more. Under N.C.G.S. 105-236(a)(5)(b), if a taxpayer understates taxable income "by any means", by an amount equal to 25% or more of gross income, there shall be a penalty of 25% of the tax deficiency.

Ms. Clifton argued that her income understatement was attributable to her difficulty in substantiating her expenses and she contended that the NCDOR could not prove that her claimed deductions were improper versus merely insufficiently documented. The North Carolina Business Court reversed the earlier decision of the Administrative Office of Hearings and determined that a gross income understatement of 25% or more that results "by any means" triggers application of the 25% Large Individual Income Tax Deficiency Penalty.

# PART FIFTEEN
# OVERVIEW OF RECENT NCDOR PRIVATE LETTER RULINGS

Here are some of the more interesting NCDOR Private Letter Rulings that have been issued over the last few years. Although these PLRs do not constitute legal precedence for our clients, at least these PLR's provide us with some insight as to how the NCDOR may be viewing certain issues.

## I. Post-Harvest Produce Processing is Not the Same as "Manufacturing" for Purposes of the Mill Machinery Exemption; SUPLR 2025-0002 (May 1, 2025).

**Facts:** The taxpayer conducted post-harvest produce processing operations in North Carolina. The processed produce products were then sold for resale. The taxpayer represented that the pre-processed produce could not be resold to retailers or to consumers if they did not undergo the processing first. Therefore, the taxpayer's processing facility was necessary to convert the raw product into a consumable product for sale. The taxpayer questioned whether its post-harvest processing equipment would be classified as exempt mill machinery.

**Ruling:** The DOR ruled that the post-harvest processing was not akin to "manufacturing". The original products purchased by the taxpayer were a natural and unmanufactured product, but when put through the taxpayer's process, the processing didn't cause the product to abandon its original characteristics and remained the same regardless of whether the produce was fit for human consumption before processing. According to the DOR, "manufacturing" is the producing of a new article of use by the application of skill and labor to raw materials. To make an article "manufactured", the application of labor must result in a new and different article with a distinctive name, character or use.

Thus, the usual connotation of "manufacturing" is the making of the new product from raw or partially raw materials.

## II. Sporting Clay Ranges are "Sporting Participation Activities" and Thus are Not Subject to Sales Tax as an Admission Charge to an "Entertainment Activity" Under NCGS 105-164.4G(e)(1); SUPLR 2025 – 0001 (February 10, 2025).

The NCDOR ruled that charges to access a sporting clay course is not subject to sales tax as an admission charge to an entertainment activity, because the customers are paying to participate in the activity.

However, if the sporting clays facility rents or sells equipment to its customers, such as shotguns, ear protection, eye protection or ammunition, then those items would be subject to the regular rate of sales tax.

## III. Low Income Housing Non-Profit Corporation Isn't Eligible for Tax Refunds of Indirect Sales Tax Paid on Construction Materials to Build Housing Complex the Taxpayer Doesn't Own (October 8, 2024).

**Facts:** The taxpayer was involved in the development of an affordable housing complex in North Carolina. Low income housing tax credits would finance construction of the affordable housing project.

A North Carolina partnership (the "Partnership") was formed to own and build the affordable housing complex (the "Project"). Subcontractors hired to build the affordable housing Project incurred sales and use tax on purchases of building materials that ultimately would constitute part of the "as built" affordable housing Project.

The nonprofit corporation asked for a refund for sales and use tax on indirect purchases of building materials and supplies that were part of the real property contracts for the Project and that became a part of, or annexed to, the Project buildings and structures.

**Ruling:** The DOR ruled that the taxpayer was clearly a Section 501(c)(3) nonprofit entity that qualifies for sales and use tax refunds on eligible purchases, including those that it paid indirectly. However, in this case the North Carolina nonprofit did not indirectly incur the sales and use tax on purchases of building materials and supplies. Instead, it was the contractors and third parties that purchased the materials for the ultimate benefit of the Partnership. Therefore, it was the Partnership, and not the North Carolina nonprofit, that was indirectly incurring the sales and use tax liability on these purchases. Here, the taxpayer did not own or lease the Project's buildings or structures and instead those were owned solely by the Partnership.

## IV. NCDOR Private Letter Ruling, March 8, 2024; What Equipment Purchases by Contractor in a Construction Contract With the Taxpayer Are Exempt as Mill Machinery – SUPLR 2004-0005.

**Facts:** Here, the taxpayer was constructing a manufacturing facility and hired a contractor to build the facility and purchase equipment as part of the overall construction project. The taxpayer sought a ruling as to whether the following items, purchased by the contractor and installed into the newly constructed facility, would be exempt as mill machinery:

1. Electrical equipment and electrical power distribution equipment;
2. Compressed air systems; and
3. HVAC equipment.

**Ruling:** In the private letter ruling, the NCDOR determined:

1. Electrical equipment was not exempt mill machinery. Here, the electrical equipment was designed for the general distribution of power to the new manufacturing plant. Under Sales and Use Tax Bulletin 57-3, only electrical equipment that is ***actually***

***affixed to mill machinery*** is exempt mill machinery.

Here, the PLR request did not describe any electrical equipment that would be actually affixed to any piece of mill machinery, but instead the ruling request described the electrical equipment as being used for the general distribution of power to the building, including the assembly line. The electrical power conduit and electric wiring that ran from electrical rooms but would not be affixed to any piece of mill machinery, but instead worked for the general distribution of power to the assembly area building. Thus, the electrical equipment did not qualify under SUTB 57-4(1).

2. Compressed air system. In the ruling, the compressed air system was to be used to support the tools that would be utilized to assemble the taxpayer's products. The NCDOR determined that the compressed air system would be a non-exempt "accessory" to mill machinery because the system would be used to drive the tools that would be utilized to assemble product. Therefore, compressed air system was not mill machinery.

3. HVAC equipment. Here, the HVAC equipment qualified as mill machinery since the taxpayer's assembled products had specific temperature and humidity requirements during the assembly processes and these HVAC units were central to control the specific humidity and temperature conditions of the factory. Therefore, they qualified as mill machinery under SUTB 57-3(a).

**NCDOR Private Letter Ruling January 31, 2024; Live Content Via Audio Video Connection Subject to Sales Tax – SUPLR 2024-0004.**

**Facts**: The taxpayer operated websites which provided users the ability to interact live via an audio video connection. The taxpayer's website allowed users to see and hear taxpayer's content and interact by way of a live chat. Nothing would be downloaded by the customer.

**Ruling**: NCDOR rules that the taxpayer's customers pay for live audio and video and the taxpayer is providing a live performance and uploading original content for the entertainment of its customers and subscribers. Thus, the live video and video content meets the definition of "digital audiovisual work" which is then subject to North Carolina sales and use tax.

V. **PLR January 31, 2024; Sale of At-Home Testing Kits And Analytical Services Are Not Subject to Sales Tax – SUPLR 2024-0002.**

**Facts**: The taxpayer was an online provider of analytical reports to individual customers who purchased home testing kits from the taxpayer. Once a North Carolina customer purchased a testing kit, the customer mailed the kit from their home to the taxpayer's laboratory, where specimens are reviewed and processed and analyzed. Customers can then access their individual, personal reports through the taxpayer's website.

**Ruling**: Here, the use of the testing kit was integral to the provision of the taxpayer's services. NCDOR ruled that taxpayer was actually making direct sales of analytical reports to its North Carolina customers, but these "services" are not subject to North Carolina sales tax under in

NCGS 105-164.4. For the kits, which were used to obtain the specimen and were then returned to the taxpayer for proper processing, the kits were merely to be used by the taxpayer to perform analytical services. Since the kits were not sold separately to its customers, no sales tax should be assessed on the sale of the services or the test kits.

## IV. PLR January 3, 2024; Sale of Digital Property and Not Sale of the Software Service; Subscription Fees and Bundled Transactions – SUPLR 2004-0003.

**Facts**: The taxpayer was a technology-based training services company that charged subscription fees to allow its customers to license pre-written software through a licensing agreement on the taxpayer's technology landform. The software allowed customers to access "content" on the taxpayer's website. The content is remotely accessed and not downloaded and therefore no software was actually transferred to the end-user.

The technology platform contains a database of instructional content generally shown in the form of "live streaming content" and digital works. Each platform allows their user to search, select and curate the instructional content in which they were interested. No individual works or items were ever purchased, but instead the entire library database of content was purchased through a subscription license. The purpose of subscribing was to gain access to the overall platform and software that allows a user to select content applicable to their specific situation pulling from the entire database.

The issue was whether the subscription fees were subject to sales tax as the sale of digital property?

**Ruling**: Here, the taxpayer's customers sought and received access to digital content when they pay the subscription fee and therefore the transaction was subject to sales and use tax as the sale of the digital product. The NCDOR ruled that the taxpayer was not selling software as a service when it provided access to the digital content nor was it providing an information service. The taxpayer's customers were not purchasing underlying software used by the taxpayer to deliver content.

However, one standalone service provided by the taxpayer would not be normally subject standalone to sales and use tax. The taxpayer also would allow it customers access to the taxpayer's website to allow the customers to practice [music or yoga] found in some of the digital content. Customers did not download the software, but instead would access it remotely on the taxpayer's website. Therefore, the stand-alone sale of this product would be the sale of "software as a service" which is a nontaxable service in North Carolina. However, since this product was sold for one non-itemized price with a taxable digital price, this constituted the sale of a "bundled transaction". Therefore, the sales tax would apply to the full sales price of the bundled transaction under N.C.G.S. 105-164.4D(a).

## V. Private Letter Ruling August 23, 2023; Sales Tax on Warranty Contracts: Taxpayer-Obligor is Not Liable for Sales Tax on Warranty Contracts sold by Sub-Contractor Where the Taxpayer and the Sub-Contractor Did Not Agree That the

**Taxpayer Would be Responsible for Collecting and Remitting Sales Tax – SUPLR 2023-0003.**

**Facts:** The taxpayer manufactured and sold roofing materials to unrelated independent contractors. The taxpayer offered warranty coverage for its roofing materials and labor. Usually, if an independent contractor successfully bid on a roofing project and successfully installed the roof, the roofing contractor would offer to sell the taxpayer's warranty to the customer. The taxpayer was not be a party to the contract between the roofing contractor and the building owner.

**Ruling:** Under N.C.G.S. 105-164.4I(a)(3), if a service contract is sold at retail to a purchaser by a "service contract facilitator" (the subcontractor here), it is the service contract facilitator, and not the obligor under the service contract (the taxpayer here) that must charge and collect sales tax from the customer, unless the contract specifically obligates the roofing materials supplier to be responsible for remitting sales tax on the sale of the service warranty contract. Here, the contractor was the "service contract facilitator" and the taxpayer roofing material provider was the "obligor" under the service warranty.

Therefore, it was the contractor's responsibility to collect and the remit sales tax on the sale of the service warranty contract.

## VI. Taxpayer is a "Contract Manufacturer" Whose Purchase of "Blast Freezing" Equipment for its "Blast Freezing" Operations for Food Manufacturers are Mill Machinery Exempt from Sales Tax. November 2, 2022 – SUPLR 2022-0006.

**Facts:** Taxpayer operates a facility in North Carolina with blast freezing operations.

Taxpayer takes possession of customers' perishable foods and blast freezes the goods to below 0 degrees before goods are shipped back to customers.

**Ruling:** Taxpayer is a contract manufacturer when it performs blast freezing process on customer's goods for manufacturers of those goods. Thus, taxpayer's purchase of blast freezing equipment is mill machinery exempt from sales tax.

## VII. Sales of "Help Desk Services" are Sales of Service Contracts Subject to Retail Sales Tax. July 27, 2022 – SUPLR 2022-0004.

**Facts:** Taxpayer provides Information Technology Services to business organizations under a service level agreement (an "ITS Plan").

The ITS Plan allows customers to "outsource" all of their IT needs with taxpayer's virtual, remotely accessed IT infrastructure. Taxpayer's technology assets are maintained in a facility located outside of North Carolina.

In addition to providing its customers with data storage, data security and data protection, taxpayer also provides "Helpdesk" technical support for a fee.

**Ruling:** Taxpayer's sale of Helpdesk services are taxable sales of service contracts and thus subject to sales tax.

## VIII. Purchase of Sorting, Bailing and Weighing Equipment Not Exempt from Sales Tax as Mill Machinery Because Taxpayer is Not a "Manufacturer". June 9, 2022 – SUPLR 2022-0003.

**Facts:** Taxpayer collects used goods and undertakes following activities to process used goods into products that can be sold to end-use customers:

Sorting – taxpayer uses specialized machinery to sort damaged and undamaged goods into different categories.

Bailing – taxpayer uses equipment to crush and compact materials into compressed bales in specific sizes.

Weighing – taxpayer uses calibrated scales to determine product weight.

**Ruling:** Taxpayer is not a manufacturer, and therefore its purchase of equipment are not exempt from sale tax under mill machinery exemption.

## IX. Purchases of Equipment by Contract Manufacturer Performing Contracts to Provide Anodizing Services to Manufacturing Plant is Exempt Mill Machinery. November 8, 2021 – SUPLR 2021-0027.

**Facts:** Taxpayer purchases equipment to fulfill contracts with manufacturing industries or plants to provide aluminum anodizing services for commercial and individual customers.

**Ruling:** Taxpayer is a "contract manufacturer" performing anodizing service contracts with manufacturing industries or plants.

So, purchase of equipment by taxpayer is "mill machinery" exempt from sales tax, as sale of mill machinery to a contractor for its use in performing a contract with a manufacturing plant. N.C.G.S. 105-164.13(5e)b.

## X. Recycler is a "Manufacturer" and thus Purchase of Equipment Used In Its Production Process is Exempt from Sales Tax Under Mill-Machinery Exemption. October 29, 2021 - SUPLR 2021-0026.

**Facts:** Taxpayer purchases equipment used in its recycling business. Taxpayer produces a variety of new, different and distinct products with a commercial value in excess of the original raw materials.

**Ruling:** Taxpayer applies its skill and labor to convert collected paper, plastic and metals into finished goods that conform to industry and customer standards. Thus, taxpayer's recycling activities constitute "production" and its purchase of certain equipment used in its recycling process is mill machinery exempt from sales tax.

## XI. Sales of Educational On-Line On-Demand Courses Subject to Sales Tax. June 22, 2021 – SUPLR 2021-0023.

**Facts:** Taxpayer offers on-line and on-demand courses to students in public and private schools.

**Ruling:** Receipts from sales of on-line courses constitute sales of digital audiovisual works and thus are taxable sales of digital property under N.C.G.S.105-164.3(59).

## XII. The Following Constituted Taxable Sales of "Digital Property" Under N.C.G.S. 105-165.3(5) and (33) – SUPLR 2021-0019; April 29, 2021.

**Ruling**: Subscription fees paid to access industry research in the cloud through a web portal.

**Ruling:** Charges for on-line training courses accessed on digital platforms, including on the taxpayer's website. March 20, 2020.

## XIII. Testamentary Trust Not Subject to North Carolina Taxation. June 21, 2021 – Request for Written Determination issued June 1, 2021.

Trust established by North Carolina resident prior to his death.

**Facts:** Trust does not own any real estate and does not participate in any partnership or business activities. Trust income is only from intangible investments, none of which are "North Carolina based."

No trust beneficiaries are residents of North Carolina.

**Ruling:** Trust is not required to file North Carolina fiduciary income tax returns, regardless of whether income is distributed to beneficiaries or retained by the trust, because the trust neither (1) derives income from NC sources nor (2) derives any income for the benefit of a North Carolina resident.

**Note:** PLR does not indicate whether (1) trustee or (2) investments are located inside or outside of North Carolina.

## XIV. Contractor's Purchase of Water Purification Device to Perform Construction Contract with "Manufacturing Plant" is Exempt as Mill Machinery. May 19, 2021

**– SUPLR 2021-0021.**

**Facts**: Taxpayer purchases a water purification device to perform a construction contract for a customer's manufacturing plant.

**Ruling:** Taxpayer's purchase of a water purification device, that is installed by the taxpayer into a newly-constructed water purification plant, that in turn is considered a manufacturing plant, is exempt from sales tax under mill machinery exemption of N.C.G.S. 105-164.13(5e)6.

## XV. Roof Repair Not a "Capital Improvement" Exempt From Sales Tax, Even Though Customer Capitalized the Cost for Federal Tax Purposes. February 25 2021-SUPLR 2021-0011.

**Facts**: Taxpayer makes substantial roof repairs to customer's commercial building. Single roof repair project at great expense, although entire roof was not replaced.

Customer capitalizes the cost of roof repairs for federal tax purposes.

**Ruling:** Although customer capitalized the roof repair costs for federal tax purposes, because the roof repair did not constitute "installation of **equipment** or a **fixture** that is attached to real property" under N.C.G.S. 105-164.3(31)(d), and since the roof was not fully replaced, the fact that customer capitalized the cost of the roof for federal tax purposes doesn't qualify the roof repair as a "capital improvement" exempt from sales tax.

## XVI. Purchase of Certain HVAC Units Qualify for Mill Machinery Exemption – January 26, 2021 – SUPLR 2021-0001.

**Facts**: Taxpayer is manufacturer of extruded foam products sold to end-users or as components for other manufacturers. The taxpayer's products are used in the following industries: construction, packaging, furniture and fitness.

Taxpayer purchases an HVAC unit to be installed above its production area and the purchased HVAC unit operates separate and apart from other HVAC equipment in taxpayer's facility.

**Ruling:** Taxpayer is a manufacturer and its purchase of HVAC equipment is eligible for mill machinery sales tax exemption under N.C.G.S. 105-164.13(5e).

## XVII. Subscription Fees to Access On-Line Training Courses are Subject to Sales Tax. February 20, 2020 – SUPRL 2020-0003.

**Facts:** Taxpayer provides on-line training courses via subscription.

Taxpayer contracts with subject matter experts who create pre-recorded training courses.

Taxpayer charges monthly or annual subscription fee to customers in exchange for providing subscribers with a "non-exclusive, non-transferrable license" to use taxpayer's site.

**Ruling:** Taxpayer's subscription fees are taxable sales of digital property (audiovisual works) subject to sales tax.

## XVIII. Limited Partnerships Not an "Investment Partnership" and Therefore Must File North Carolina Partnership Return and Pay North Carolina Tax on Behalf of Non-Resident Partners. January 31, 2020 – Request for Written Determination issued January 31, 2020.

**Facts:** Limited partnership owns North Carolina real estate and recently sold one piece of real estate. Partnership is not engaged in an on-going business. Partnership has some seasonal rental income and has sold property in the past.

Limited partnership has six partners, and only one partner resides in North Carolina.

Proceeds from recent sale of real property will be distributed to non-resident partners.

**Ruling:** Partnership is deemed to be "doing business" in North Carolina because it holds "real property for appreciation and income." Partnership is not an "investment" partnership and thus does not meet the North Carolina partnership return filing exemption of Administrative Rule 17 N.C.A.C. 06B.3503(c).

## XIX. Auctioneer's Administrative Fees Subject to Sales Tax. February 28, 2020 – SUPLR 2020-0004.

**Facts:** Taxpayer sells new and used goods through unreserved public auctions. Owners of the goods (consignors) consign the goods to the taxpayer for auction, but reserve title to the consigned items.

Taxpayer merely acts as "selling agent" for owners of the items.

Taxpayer collects sales tax from buyers at auction but proposes a new arrangement where taxpayer also will charge an administrative fee to buyers for the "many valuable services" it offers to the buyer.

The new administrative fee will be based on the sales price of the item and will be "separately stated" on buyer's invoice.

**Ruling:** Administrative Fee is part of the sales price subject to sales tax.

## XX. Customer Fees Charged to Customers Who Purchase Items from Taxpayer are Subject to Sales Tax. November 12, 2019 – SUPLR 2019-0002.

**Facts:** Taxpayer plans to charge a fee to customers who purchase an item.

Customer fee is a percentage of the charge for the item and would be added at the time of purchase.

Customer fee would be "separately stated" and charged at the time of purchase.

**Ruling:** Customer fee is an expense of the retailer and is part of the sales price of the item. So, the customer fee is subject to retail sales tax.

## PART SIXTEEN
## NORTH CAROLINA DEPARTMENT OF REVENUE PROCEDURAL CHANGES

### I. NC Says it Will Start Recognizing Powers of Attorney In 2025

**A. Background**. In 2019, the General Assembly enacted legislation that directed the NCDOR to update its electronic data systems to store and recognize power of attorney registrations to ensure that notices are simultaneously sent to both the taxpayer and the taxpayer's representative at the same time. Session Law 2019-246 (November 8, 2019). But up until now, even with a valid Form GEN-58 in hand, the NCDOR still does not send copies of notices to the taxpayer's representative.

**B. NCDOR Issues "Important Notice" Power of Attorney Form Updated to Authorize Representatives to Receive Copies of Available Notices; August 20, 2024**.

The NCDOR has announced it is updating its systems to send copies of NCDOR notices to authorized representatives. Once this update is complete, the NCDOR will start sending notices to the authorized representatives. The NCDOR experts to start sending notices to authorized representatives **in early 2025.**

To make sure the authorized representative will start receiving copies of NCDOR Notices sent to the taxpayer, the taxpayer must submit new POA (even if you already have one on file) which includes the following information:

- Email address for authorized representatives;
- Tax periods covered by NCDOR notices to be sent out; and
- The taxpayer **must "check the new box"** on Form Gen-58 (located at the bottom right corner of the block for designated representative's name and contact information).

**Note:** The NCDOR will only send copies of ***certain notices***. To see types of notices of which the NCDOR will be sending copies to the authorized representative, see the NCDOR website.

### II. New Automatic Extension Request.

Section 38.4.(b) of the 2018 Act adds a new subsection (c) to N.C.G.S. 105-263 to now provide that any taxpayer who receives an automatic extension of time to file a federal income tax turn is granted an automatic extension to file a North Carolina return, **as long as the taxpayer certifies on the state tax return that the taxpayer was granted a federal extension.**

> **Note**: Please note however, that this Section becomes effective for taxable years beginning on or after January 1, 2019; as a result, **we will have to file a separate state extension for 2018 tax returns.**

## III. Electronic Filing of Informational Returns.

The 2018 Tax Act also provides for a new $200 penalty per return for the failure to file certain information returns electronically. New N.C.G.S. 105-236(a)(10)d. In addition, the new Act adopted N.C.G.S. 105-241A(e) which requires that the NCDOR publish on its website a list of all returns that it requires to be filed electronically.

## IV. Penalty Waiver For Failure To File Forms NC-3 And W-2 Electronically.

On August 5, 2019, the NCDOR issued its "Important Notice: Changes To Filing Requirements For Form NC-3 For Tax Year 2019." In this Notice, the Department of Revenue noted that it was aware that some software vendors continue to fail to provide support for electronic filing of Form NC-3 or the required Form W-2 and 1099 statements. Therefore, the Department of Revenue has elected to continue the automatic waiver of the $200 penalty for failure to file the 2019 Form NC-3 in the electronic format. The NCDOR also advises that this is an automatic waiver and that no action is required by the taxpayer. The NCDOR reminded taxpayers however, that the waiver doesn't alleviate the taxpayer's responsibility to otherwise timely file Form NC-3 and Forms W-2 and 1099 on time.

Please note that the due date of the 2019 Form NC-3 is January 31, 2020 and that if a taxpayer does not timely file Form NC-3 by paper or electronically on or before January 31, 2020, the NCDOR will impose a failure to timely file penalty under N.C.G.S. 105-236(a)(10)c. This failure to file penalty is $50 per day up to a maximum of One Thousand ($1,000) Dollars.

## V. Waiver Of Failure To File Penalty For Failure To File Certain Forms 1099-MISC.

In its "Important Notice" dated August 5, 2019, the NCDOR advised that it was aware that certain software vendors did not provide adequate support for the electronic filing of federal Forms 1099-MISC with the North Carolina Department of Revenue. The Notice also advised that the NCDOR understood that printing and filing paper copies of federal Form 1099-MISC statements is burdensome and time-consuming for businesses and accounting firms. Therefore, for the tax year 2019, the NCDOR will not require taxpayers to submit a paper or electronic copy of any federal Form 1099-MISC that does not report North Carolina income tax withheld. However, if a federal Form 1099-MISC statement reports North Carolina income tax withheld, then that Form 1099-MISC must be filed with the NCDOR as part of the taxpayer's annual report filing requirements.

## VI. New Changes To Contractor Withholding Rules.

Senate Bill 523 (July 26, 2019) made significant amendments to N.C.G.S. 105-163.3, which requires that any payer paying more than $1,500 in a calendar year to an ITIN contractor to withhold 4% of income tax on the compensation being paid to the ITIN contractor.

ITIN workers are individuals who are required to have a U.S. taxpayer identification number but who do not have, and are not eligible to obtain, a social security number from the Social Security Administration. The IRS issues ITINs to "help" individuals comply with U.S.

tax reporting requirements. ITINs typically are issued to resident and non-resident aliens who have U.S. reporting and filing obligations. Individuals typically obtain an ITIN because they have a tax return filing requirement or are required to furnish an ITIN to a payor.

ITINs always start with the number "9".

Under the amended N.C.G.S 105-163.3, effective January 1, 2020, a payer must deduct and withhold 4% North Carolina income tax from nonwage compensation paid to a "payee" if the payer expects to pay more than $1,500 to the payee in that calendar year. Under N.C.G.S. 105-163.1(9a), a "payee" is defined as any of the following:

1. A non-resident contractor that provides a performance, entertainment, athletic event, speech or creation of film, radio or television program here in North Carolina.

2. An ITIN contractor, including someone who is applying for an ITIN and someone who has an expired ITIN.

3. Any person who performs services in North Carolina who fails to provide the payer a taxpayer identification number.

4. A person who performs services in North Carolina that fails to provide the payer a valid taxpayer identification number. (And, for this purpose, the NCDOR must notify the payer that the ITIN is invalid and if that happens, then the withholding requirement only applies to compensation paid to that payee after that date).

The withholding requirement applies to any payer who expects to pay more than $1,500 of nonwage compensation to the payee during that calendar year. However, tax is not required to be withheld from the payment of compensation to a payee if the payment is $1500.00 or less and at the time the payment is made, the payer does not believe that the total compensation to be paid to the payee during the year will exceed $1,500.00. If additional compensation paid to the payee later in the year causes total compensation for the year to exceed $1,500.00, the payer is only required to withhold tax from the additional compensation and does not have to make up from the compensation for which no tax was withheld.

On October 18, 2019, the North Carolina Department of Revenue issued Notice Directive TA-19-1 and provides a specific example of how these new rules will work. In the example provided in the Directive, the payer pays a payee $900 in January 2020 and does not expect to make any further payments to the payee in 2020. Because the compensation is $1500.00 or less, no tax is required to be withheld. However, later in 2020, the same payee is paid an additional $800.00. In this case, the payer must withhold $32.00 from the $800.00 compensation ($800 x 4%) because the total compensation paid to the payee for the year now exceeds $1500.00. In contrast, if the payer makes regular payments to the payee during the year, the total which is expected to exceed $1500, 4% income tax must be withheld from these payments.

There are certain exceptions to the new withholding rules. For example, tax is not required to be withheld from compensation paid to a non-resident entity if the entity is a

corporation or limited liability company that has obtained a certificate of authority from the North Carolina Secretary of State. However, the payer must obtain from the entity, and retain in its records, the entity's identification number issued by the North Carolina Secretary of State.

**Could A Responsible Person Be Personally Liable For Uncollected Sales Taxes Or The Failure To Do The 4% Withholding?**

Under N.C.G.S. 105-242.2, certain "responsible persons" are personally liable for sales taxes that have not been collected if the person knew, or should have known, that the sales tax was not being collected. N.C.G.S. 105-242.2(b)(2).

Likewise, N.C.G.S. 105-242.2 (b)(4) imposes personal liability on responsible persons for unpaid income taxes required to be withheld by the business. Presumably therefore, a responsible person could be held personally liable for the failure to withhold the 4% income tax on compensation paid to the above-mentioned "payees" regardless of whether the corporate officer knew or should have known of the withholding obligation.

## VII. Innocent Spouse Relief Changes

Under IRC Section 6015, an innocent spouse may be relieved from liability resulting from an understatement of tax or an underpayment of tax. Before 2019, North Carolina's innocent spouse statute provided relief to a spouse who qualified for federal innocent spouse relief for a tax assessment on a joint return "attributable to a substantial understatement." Session Law 2019-169 amended N.C.G.S. 105-153.8(e) to conform to IRC Section 6015, effective for taxable years beginning on or after January 1, 2018 so that a spouse may be relieved of liability for an underpayment of tax as well as an understatement of tax. Session Law 2019-169 (July 26, 2019).

## VIII. New Changes for Filing Your Tax Protest.

To challenge a proposed assessment of tax, a taxpayer must file a Request for a Departmental Review within forty-five (45) days after the receipt of the proposed tax assessment. Senate Bill 628 has amended Section 105-241.11 to provide that the Request for Departmental Review must be submitted on the NCDOR's form and must also contain an explanation for the request for review. This could be a "foot fault" for taxpayers who either (1) submit an informal request for reconsideration or (2) who file the correct Form NC-242 but fail to attach an explanation to their Form NC-242.

## IX. Taxpayer Inaction Can Terminate the Request for Departmental Review.

We have heard, anecdotally, that the NCDOR has received a number of Requests for Departmental Review, only to find themselves bogged down with appeals cases where the taxpayers are refusing to cooperate in their own departmental review. Therefore, under Senate Bill 628, the Legislature has added new N.C.G.S. 105-241.13A called "Taxpayer Inaction." Under this new Section, if the NCDOR sends the taxpayer a request for additional information and the taxpayer fails to respond within thirty (30) days, then the NCDOR must issue a second

notice to re-issue its request for additional information and, if the taxpayer fails to timely respond after the second information request is sent, the assessment will become final. These administrative changes are effective as of August 11, 2017 and apply to requests for departmental review filed after that date.

## X. Required Reporting to the Department of Revenue Upon Certain Federal Tax Adjustments.

N.C.G.S. 105-159 provides the general rule that, after an IRS audit, you must report any income tax changes to the North Carolina Department of Revenue within six (6) months after the audit is completed. House Bill 59 (Session Law 2017-39) amended N.C.G.S. 105-159 to now provide that, if there is an IRS audit that relates to a change of filing status, personal exemptions, standard deductions or itemized deductions, then that information also must be reported to the North Carolina Department of Revenue within six (6) months after the conclusion of the federal tax audit.

Also, under the 2018 Act, N.C.G.S. 105- 241.8(b) has been amended to now require that any taxpayer, that **voluntarily** files an amended federal income tax return, must also file an amended state tax return within six months after filing the amended federal return. Under existing law, if there is an IRS audit that results in assessment of additional tax, then the taxpayer has six months to file an amended North Carolina return to reflect the changes arising from the federal audit.

## XI. Filing Protective Refund Claims.

**A. Background.** For many years, the NCDOR has had a protective refund claim policy that taxpayers could follow in order to protect their right to a potential tax refund based on some type of contingent event for a taxable period for which the statute of limitations was about to expire. Under the old protective refund claim policy, the NCDOR would accept a protective claim for refund as long as the refund claim:

(1) was filed before the expiration of the statutory refund claim period;

(2) identified and described the contingencies affecting the claim;

(3) was sufficiently clear and definite to alert the NCDOR as to the essential nature of the claim; and

(4) identified the tax schedule and the specific year for which the protective claim was filed.

**B. New N.C.G.S. 105-241.6(B)(5) Replaces The Old Protective Refund Claim Policy.** House Bill 14, enacted in 2013, added a new exception to the general statute of limitations for obtaining a refund of an overpayment of tax due to a contingent event or an event or condition other than a contingent event. Under new N.C.G.S. 105-241.6(b)(5), if a taxpayer is subject to a contingent event, or an event or condition other than a contingent event, and

timely files a notice with the NCDOR, then the period for requesting a refund for an overpayment of tax will be six (6) months after the contingent event or other condition is concluded.

For purposes of the new statute, the term **"contingent event"** is defined as litigation or a state tax audit initiated prior to the expiration of the statute of limitations that prevents the taxpayer from possessing the information necessary to file an accurate and definite request for refund of overpayment. In addition, the new statute defines an **"event or condition other than a contingent event"** as an event or condition other than litigation or a state tax audit that has occurred that prevents the taxpayer from filing an accurate and definite request for refund of an overpayment within the general statute of limitations period.

**C. <u>Contingent Event Claims</u>**. The following is a summary of the steps that should be taken for protective claims involving a "contingent event."

First, a taxpayer who is subject to a "contingent event" must file written notice with the Department of Revenue prior to the expiration of the statute of limitations.

Although no specific form is required to be filed to provide such notice to the NCDOR, the new statute provides that the notice must identify and describe the contingent event, the type of tax involved and the tax return or payment affected by the contingent event. And, the notice must state in clear terms the basis used to determine the estimated amount of the overpayment.

The taxpayer may simply file a Form NC-14, Notice of Contingent Event or Request to Extend Statute of Limitations.

The NCDOR will then notify the taxpayer in writing that either (1) the contingent event notice has been received with all of the required information or (2) the contingent event notice has been received without all the required information.

Ultimately, the taxpayer must file a Request for Refund of an Overpayment within **six (6) months** after the contingent event concludes. And, the taxpayer must also submit a copy of the Department of Revenue's acknowledgement of an accepted notice when it files its refund claim.

**D. <u>Event Or Condition Other Than A Contingent Event</u>.** A taxpayer who contends that an event or condition (other than litigation or a state tax audit) has occurred that prevents the taxpayer from filing an accurate and definite request for refund of an overpayment prior to the expiration of the statute of limitations may submit a written request to the NCDOR seeking an extension of the statute of limitations on which to file a request for a refund of an overpayment.

The request seeking an extension of the statute of limitations must be filed prior to the expiration of the statute of limitations. And, the request must establish, by clear convincing proof, that the event or condition is beyond the taxpayer's control and that it prevents the taxpayer from timely filing an accurate and definite request for refund of an overpayment.

The taxpayer may also use Form NC-14 to request an extension of the statute of limitations. The NCDOR will then respond in writing as to whether or not the request for an extension of the statute of limitations is granted or declined. If the NCDOR grants the request to extend the statute of limitations, then the taxpayer must file a refund claim within six (6) months after the event or condition concludes, and must submit, with the request for refund, a copy of the NCDOR letter granting the request for an extension of the statute of limitations.

**E. New Six (6) Months Deadline For Filing Request For Refund.** Under the former North Carolina protective refund policy, the taxpayer did not have a deadline to perfect the protective refund claim. Now, under the new statutes, the taxpayer must file a definitive refund claim within **six (6) months** after the contingent event concludes.

**F. Where to Mail the Form NC-14.** The Form NC-14 should be mailed to the North Carolina Department of Revenue, PO Box 871, Raleigh, NC 27602-0871, and on the envelope, the taxpayer should note which tax division the notice should be sent to.

New N.C.G.S. 105-241.6(b)(5).

**See North Carolina Department of Revenue Notice: *"Exception to the General Statute of Limitations for Certain Events".***

## XII. North Carolina Voluntary Disclosure Program.

**A. Background.** The North Carolina Voluntary 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 (VDP) 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 that have failed to file returns and pay any taxes due to the North Carolina Department of Revenue (NCDOR). 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.

VDP does not apply to a taxpayer that files a return but underreports 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 NCDOR prior to initial contact by this agency concerning the filing of a return and the payment of a tax. Voluntary disclosure includes requests by taxpayers submitted under the Multistate Tax Commission National Nexus Program.

A major component of the VDP is to resolve sales and use, and corporate income and franchise tax liabilities when nexus is the central issue.

## XIII. Qualifying for Voluntary Disclosure

To qualify for the Voluntary Disclosure Program, a taxpayer must meet all of the following criteria:

- The taxpayer has not been contacted by the Department of Revenue, Internal Revenue Service or Multistate Tax Commission with respect to any tax for which the taxpayer is requesting voluntary disclosure.
- The taxpayer does not have outstanding tax liabilities other than those reported through the voluntary disclosure.
- The taxpayer is not under audit for any tax.
- The taxpayer pays the tax due plus accrued interest within 60 days from the date of acceptance by NCDOR of the voluntary disclosure agreement.
- 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.
- The taxpayer cannot have previously participated in the Voluntary Disclosure Program.

## IVX. Benefits of Voluntary Disclosure

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

- A requirement to file returns and pay tax will be limited to three years for taxes filed annually or thirty-six months for taxes that do not have an annual filing frequency. If the applicant has collected taxes from others, such as sales and use taxes or withholding taxes and not reported those taxes for periods beyond three

years or thirty-six months, the requirement to file and pay will be extended to cover those periods.

- The requirement to file returns and pay taxes for taxpayers discovered through examination that are not registered or non-filers is six years for taxes filed annually or seventy-two months for taxes that do not have an annual filing frequency. Under the VDP, the requirement to file returns and pay taxes for three years or thirty-six months refers to returns that are currently past due. To determine the filing requirement for voluntary disclosure for taxes that are filed annually, a taxpayer would file the most recent return that is past due, plus returns for the two (2) previous years. To determine the filing requirement for taxes that do not have an annual filing frequency, a taxpayer would file the most recent return that is past due, plus returns for the previous thirty-five (35) months.

- Waiver of penalties, unless the taxpayer collected a trust tax such as sales and use tax or withholding tax but did not pay it to the Department. If trust taxes were collected, the Department will waive all penalties except the 10% penalty for failure to pay the tax when due.

- When applicable, the ability to report the applicable tax liability in a spreadsheet format versus filing a return for each period involved.

- Sixty (60) days from the Voluntary Disclosure Agreement date to determine the liability and prepare the returns or spreadsheets and pay the amount of tax and interest due.

## XV. How to Apply

Taxpayers or their representative can anonymously complete the program application for businesses taxes or individual income and mail it to the following address:

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

## XVI. Review and Approval of Voluntary Disclosure Requests

NCDOR will review an application for voluntary disclosure and it will be approved, rejected, or a counter proposal made. Once the application has been approved, NCDOR will sign a Voluntary Disclosure Agreement and send it to the taxpayer or representative of the taxpayer for proper signatures.

If NCDOR determines that the taxpayer does not qualify for voluntary disclosure, the taxpayer or representative of the taxpayer will be notified.

In the event of misrepresentation of information and applicable tax data by the taxpayer or representative, the agreement can be voided and the NCDOR can take action as if the agreement does not exist.

## XVII. Audits for Voluntary Disclosure Period

NCDOR reserves its right to audit a taxpayer's books and records, subject to the time limits per G S 105-241 8 The audit may include all or part of a voluntary disclosure period.

NCDOR 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.

A taxpayer contacted by the Department for the purpose of examination after an application for voluntary disclosure has been submitted, but prior to acceptance of the agreement by NCDOR, may disclose same to suspend audit activity pending acceptance into the VDP.

## XVIII. 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.

## IXI. Any Questions?

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

# PART SEVENTEEN
# TRUST FUND TAX COLLECTION

## I. 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 the general partner of a partnership, 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.

## II. Responsible Person Liability Statute of Limitations Period Is Amended.

Effective May 11, 2016, N.C. Gen. Stat. §105-242.2(e) was amended to provide that the statute of limitations for assessing a responsible person for unpaid taxes of a business entity "expires the later of (i) one year after the expiration of the period of limitations for assessing the business entity or (ii) one year after a tax becomes collectible from the business entity under G.S. 105-241.22(3), (4), (5), or (6)."

This amendment to the period of limitations for assessing a responsible person applies to a "trust fund" tax that becomes collectible from the business entity under N.C. Gen. Stat. 105-241.22(3), (4), (5) or (6) on or after May 11, 2016. See S.L. 2016-5.

## IV. Trust Fund Recovery Criminal Exposure

H.B. 1080 amended the trust fund recovery rules to clarify that an individual may be held criminally responsible for failing to remit trust fund taxes even if that person is not a "responsible person" under N.C.G.S. 105-242.2. As a result of this change, an individual can be held criminally responsible for aiding and abetting embezzlement of N.C. state funds even if that person could not otherwise be found to be a "responsible person" for trust fund recovery purposes.

## V. New Extended Statute of Limitations for Assessing Trust Fund Tax Liability Against Employer

Also, under H.B. 1080, the statute of limitations for assessing trust fund tax liability has been expanded to 10 years from the later of the due date of the return or the date the return was actually filed. Under prior law, the NCDOR had a three-year statute of limitations unless it could prove there was some type of fraud involved. N.C.G.S. 105-241.8(b)(2a).

## V. Could A Responsible Person Be Personally Liable For Uncollected Sales Taxes Or The Failure To Do The 4% Withholding?

Under N.C.G.S. 105-242.2, certain "responsible persons" are personally liable for sales taxes that have not been collected if the person knew, or should have known, that the sales tax was not being collected. N.C.G.S. 105-242.2(b)(2).

Likewise, N.C.G.S. 105-242.2 (b)(4) imposes personal liability on responsible persons for unpaid income taxes required to be withheld by the business. Presumably therefore, a responsible person could be held personally liable for the failure to withhold the 4% income tax on compensation paid to "payees" as defined in N.C.G.S. 105-163.1 and 163.3 regardless of whether the corporate officer knew or should have known of the withholding obligation.

## VI. Trust Tax Recovery Program Closed for New Applicants as of June 1, 2016.

The North Carolina Department of Revenue announced that it is no longer accepting new applicants for the Trust Tax Recovery Program effective June 1, 2016. The program was launched in 2014 as a way for businesses to recover from tax liabilities. The Trust Tax Recovery Program offered penalty and fee waivers, as well as payment plans, to taxpayers that had outstanding liabilities for sales, withholding and other trust fund taxes.

The North Carolina Department of Revenue advises that taxpayers currently enrolled in the program should continue making their scheduled payments until they have resolved their liability.

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

Under N.C.G.S. 105-242.2, the North Carolina Department of Revenue is authorized to assess a "responsible officer" for unpaid sales taxes of a corporation or an LLC. The term "responsible officer" is defined to include the manager of an LLC. Moreover, it is irrelevant to the determination of liability whether the manager had the authority to collect and/or remit the tax; managers are considered responsible officers and may be held personally liable.

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

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

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

Also, the Articles of Organization for the LLC listed the Taxpayer as one of the "Organizers" of the LLC. Also, Article VIII, Managers, Section 8.2(b) of the Operating Agreement for the LLC, provided that the Taxpayer was appointed one of the managers of the LLC and by signing the agreement, he accepted the appointment. Also, the Taxpayer was listed as the registered agent of the LLC on the Secretary of State's website.

**Conclusions of Law**

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

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

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

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

collected by the corporation, and the term "responsible officer" is defined to include the corporation's president.

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

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

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

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

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

However, that statute (N.C.G.S. 105-164.38(b)) also states that the buyer must withhold part of the purchase price for the payment of the seller's sales tax liabilities, 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.

## IX. Continued Criminal Enforcement Actions.

See "Press Releases" at http://www.dor.state.nc.us/press/index.html

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