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2022 NCACPA NORTH CAROLINA STATE TAX UPDATE

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Introduction

On June 21, 2017, the North Carolina General Assembly adopted House Bill 59 (Session Law 2017-39). Senate Bill 257 (Session Law 2017-57) brought us decreases in the income and corporate tax rate, as well as increases in the standard deduction amounts. Senate Bill 628 (Session Law 2017-204) was enacted in August 2017 and included a number of clerical and technical changes.

On June 1, 2018, the North Carolina General Assembly enacted the Appropriations Act of 2018 (S.B. 99; Session Law 2018-5) which made a number of changes to North Carolina's tax code, including a number of provisions that decouple North Carolina's tax code from the federal Tax Cuts and Jobs Act of 2017 (the "TCJA") and the federal Bipartisan Budget Act of 2018 (the "BBA").

On July 26, 2019, the North Carolina General Assembly enacted S.B. 523 (Session Law 2019-169) containing several changes to the North Carolina Tax Code, and then on November 1, 2019 and on November 8, 2019 Session Law 2019-237 (H.B. 399) and Session Law 2019-246 (SB557) were enacted adding several more changes to the North Carolina Tax Code.

In 2020, U.S. Congress enacted two significant pieces of tax legislation. First, the Taxpayer Certainty and Disaster Relief Act of 2019 ("TCDRA") extended a number of federal tax provisions that were scheduled to expire at the end of 2019. Then, the Coronavirus Aid, Relief and Economic Security Act (the "CARES Act") was enacted to provide tax relief to taxpayers during the COVID-19 crisis.

In its 2020 summer legislative session, North Carolina Session Law 2020-58 (H.B. 1080), adopted some, but not all, of the changes enacted under TCDRA and the CARES Act.

In the summer of 2021, two bills were introduced before the General Assembly: HB 334 and SB 105, to propose changes to the North Carolina tax system. On November 18, 2021, Governor Cooper signed Senate Bill 105 (Session Law 2021-180) into effect.

Session Law 2021-180 (November 18, 2021) made the following changes **effective January 1, 2020:**

- Added a new North Carolina deduction for certain Military Retirement benefits.
- Delayed the North Carolina "add back" for business expenses paid with forgiven PPP loan proceeds until 2023.
- Allows taxpayers to amend their 2020 North Carolina tax returns to claim refunds for added back business expenses paid with forgiven PPP loan proceeds.
- Exempts from North Carolina tax amounts from Economic Injury Disaster Loans ("EIDL") loans and grants and SBA loan payments.
- Excludes certain Unemployment Compensation benefits for 2020.
- Establishes the PTE state tax cap work-around for North Carolina.

Session Law 2022-06 (March 17, 2022) and Session Law 2022-13 (June 29, 2022) made further changes. These sessions contain all of the tax changes that we should expect to see this year, such as:

- The gradual reduction of the late payment penalty.
- Allows North Carolina deductions for expenses that qualify for the Employer Retention Credit.
- Exempts payments from North Carolina Recovery Grant program, RETOOLNC grants and certain rent and utility assistance payments.
- Confirms that a PTE is not required to pay estimated taxes if it did not elect PTE status in the prior year.
- All effective beginning in 2020.

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, 2022, 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 (FOR 2020, 2021 AND 2022)

I. NCDOR Publishes New Individual Income Tax Bulletin.

On January 2, 2020, the North Carolina Department of Revenue published a 2019 Personal Income Tax Bulletin providing the NCDOR's administration and application of individual income tax laws in effect as of January 1, 2020. This Bulletin addresses and reviews the definition of a North Carolina resident and the application of the North Carolina income tax rules to non-residents and part-year residents. In addition, although the Bulletin is labeled as a "Personal Income Tax Bulletin", the Bulletin also sets forth a summary of the rules relating to filings by partnerships and "S" corporations, as well as with respect to fiduciary tax filing requirements for estates and trusts. Furthermore, the Bulletin also addresses payor responsibility for tax withholdings and reportings.

II. New Increased Standard Deduction Amounts.

SB 257 (2017) and SB 105 (2021) increased the standard deduction as follows:

	2019	2020 & 2021	2022
Filing Status	Standard Deduction Amounts	Standard Deduction Amounts	Standard Deduction Amounts
Single	$10,000	$10,750	$12,750
Married filing separately	$10,000	$10,750	$12,750
Married filing jointly	$20,000	$21,500	$25,500
Head of Household	$15,000	$16,125	$19,125

III. New Individual Tax Rates.

SB 105 (2021) reduced the flat individual tax rates from 5.25% as follows:

Tax Year	Tax Rate
2021	5.25%
2022	4.99%
2023	4.75%
2024	4.6%
2025	4.5%
2026	4.25%
Years after 2026	3.99%

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%.

IV. 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, NC 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 NCGS 105-153.5(b)(5a), the following items of military retirement pay and survivor benefits are deductible for (non taxable) 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 NC 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)."

V. North Carolina Temporarily Reduces the Late Payment Penalty

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 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 could not accommodate this quick change.

So, on June 29, 2022, Governor Cooper signed Session Law 2022-13 (House Bill 83), which made several changes to North Carolina tax system. The legislation continues the current penalty rate of ten percent (10%) through December 2022, and then temporarily reduces the penalty rate to five percent (5%) from January 2023 to June 2024. Then, beginning in July 2024, 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%.

VI. 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. NCGS 105-269.8(c).

VII. Review of North Carolina Itemized Deductions.

Under prior law, beginning in 2014, taxpayers who itemized their deductions for federal tax purposes were **limited** to the following itemized deductions for North Carolina tax purposes beginning in 2014:

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.

However, under HB 97 (2015), beginning in 2015, the medical expense deduction for itemizers was reinstated. So, for 2015 and beyond, North Carolina will allow 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.

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).

VIII. 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
N.C. DECOUPLES FROM 2020 FEDERAL TAX LEGISLATION

The U.S. Congress enacted two significant pieces of tax legislation in 2020. First, the Taxpayer Certainty and Disaster Relief Act of 2019 ("TCDRA") extended a number of federal tax provisions that were scheduled to expire at the end of 2019. Then, the Coronavirus Aid, Relief and Economic Security Act (the "CARES Act") was enacted to provide tax relief to taxpayers during the COVID-19 crisis.

In its 2020 summer legislative session, Session Law 2020-58 (H.B. 1080), North Carolina adopted some of the changes enacted under TCDRA and the CARES Act. For example, the TCDRA extended the 7.5% itemized medical expense deduction threshold for 2019 and 2020. Under new legislation, North Carolina will follow the more favorable 7.5% itemized medical expense deduction threshold. Session Law 2020-58 (H.B. 1080).

However, H.B. 1080 also contained a number of North Carolina tax provisions designed to "decouple" from TCDRA and the Federal Cares Act. On July 20, 2020, the NCDOR issued a very well written "Important Notice" describing various decoupling provisions in HB 1080 affecting individuals and corporations. The following discussion will summarize how North Carolina differs from the tax relief provisions under the TCDRA and the Cares Act.

A. No Deduction for Mortgage Insurance Premiums Deducted on the Federal Return. Under the federal TCDRA, mortgage insurance premiums continue to be treated as deductible mortgage interest. However, North Carolina continues to require an "add back" for mortgage insurance premiums deducted on the federal return.

B. Exclusion for Discharge of Qualified Principal Residence Indebtedness. Under the TCDRA, forgiven qualified principal residence indebtedness is excludable from gross income for federal tax purposes through the year 2020. However, North Carolina continues to require an addition to federal AGI for any cancelled debt that is excluded from federal taxable income.

C. Qualified Tuition and Related Educational Expense Deductions. Under the Federal TCDRA, in certain cases taxpayers may take a tax deduction for certain qualified tuition and related expenses. However, North Carolina requires an "add back" to federal AGI for any tuition deducted on the federal tax return.

D. Charitable Contribution Limitation. The Cares Act suspended the AGI percentage limitation (60%) on charitable contributions made in 2020. However, House Bill 1080 imposes the same AGI limitations on charitable deductions that existed before 2020 (60% of AGI). 105-153.5(a)(s)a.

E. **Changes to the Net Operating Loss Rules.** The 2017 Federal Tax Act legislation eliminated the ability to carry back NOLs.

However, the Cares Act eliminated the prohibition on NOL carrybacks for certain NOLs arising in 2018, 2019 and 2020. In addition, the Cares Act now allows NOLs that were incurred in 2018, 2019 or 2020 to be carried back as far as 5 years.

The 2017 federal Tax Act also placed an 80% limitation on the amount of taxable income that could be offset by an NOL. However, the Cares Act eliminated the 80% limitation for NOLs **incurred in 2018, 2019 and 2020.**

House Bill 1080 now requires that individual taxpayers "add back" the amount of any 2018, 2019 or 2020 NOL carried back into a prior year. NCGS 105-153.5(c2)(8). However, the amount of any North Carolina "add back" can be deducted over the next five (5) years starting in 2021. NCGS 105-153.5(c2)(14).

Likewise, North Carolina kept in place the 80% AGI taxable income limitation. So, any NOLs deducted for federal tax purposes in excess of the 80% limitation must be added back to the federal taxable income and then can be deducted in five (5) equal annual installments beginning in 2021. N.C.G.S. 105-153.5 (c2)(13) and (16).

F. **Qualified Educational Loans.** The Cares Act expanded the gross income exclusion for 2020 for educational assistance in the form of interest and principal payments on qualified education loans paid by an employer. North Carolina, however, requires an add back for North Carolina tax purpose. NCGS 105-153.5(c2)(18).

G. **Net Business Losses.** Under the 2017 federal Tax Cuts and Job Act, there was a limit put in place on the amount of excess business losses that could be deducted by non corporate taxpayers. Under the Cares Act, this new limitation will be **retroactively** delayed until 2021. House Bill 1080 now requires individual taxpayers "add back" any business losses deducted for federal tax purposes in 2018, 2019 and 2020 over and above the amount that would have been deductible prior to the enactment of the Cares Act. NCGS 105-153.5(c2)(12). The add back amount may then be deducted on the North Carolina individual returns in 5 equal installments beginning in 2021. NCGS 105-153.5(c2)(15).

H. **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.

However, Session House Bill 1080 requires both corporate and individual taxpayers to "add back" the additional interest expense deduction. N.C.G.S. 105-153.5 (c2)(17).

PART THREE
NEW DEVELOPMENTS SURROUNDING ECONOMIC STIMULUS INITIATIVES.

On November 18, 2021, Governor Cooper enacted **Session Law 2021-180** (Senate Bill 105) which made significant changes to North Carolina Tax Administration to conform with the Federal Consolidated Appropriation Act 2021 (CAA) and the American Rescue Plan Act of 2021 (ARP).

On December 10, 2021, the North Carolina Department of Revenue issued "Important Notice: Impact of Session Law 2021-180 on North Carolina Individual and Corporate Tax Returns."

Session Law 2022-13 (June 29, 2022) also made changes to North Carolina tax treatment of certain economic stimulus programs.

The following changes are noted in the Important Notice along with changes under Session Law 2022-13 (June 29, 2022).

A. Expenses Paid With PPP Loan Proceeds. As we all know by now, forgiven PPP Loans are no longer subject to Federal Taxation as a result of the CARES Act.

North Carolina has followed the federal exclusion. House Bill 1080, SL 2020-58.

Next, what about other ordinary and necessary deductible business expenses paid with PPP Loans? Under Section 265 of the Internal Revenue Code, normally no deduction is allowed for otherwise ordinary necessary expenses paid with tax exempt income. However, under the CCA, eligible expenses paid with PPP loan proceeds are indeed deductible for federal income tax purposes. In 2020, the General Assembly enacted legislation (NCGS 105-153.5(c)(2)(20) for corporations and NCGS 105-130.5(a)(32) for individuals) that otherwise required that North Carolina taxpayers "add back" the amount of expenses deducted on the federal return to the extent those expenses were paid with PPP loan proceeds. See House Bill 1080, S.L. 2020-58.

However, in 2021, the General Assembly amended these statutes with the effect of delaying the "add back" until tax years **beginning after January 1, 2023**. This effectively means two important things:

First of all, as long as PPP loan proceeds are used to pay ordinary, necessary business expenses in tax years **before 2023**, then no State add back will ever be required.

Second, if taxpayers have already added back to their federal taxable income in 2020, then these taxpayers should file amended North Carolina tax returns to claim their refund. Please note that, in its Important Notice, the NCDOR advised taxpayers that the NCDOR will **not** automatically generate a tax refund for North Carolina taxpayers that overpaid their North Carolina income tax by otherwise including the "add back" for ordinary, necessary business expenses paid with PPP Loan proceeds.

B. Other Relief Items Excluded from Federal Taxable Income.

The Federal CCA also has other exclusions from federal taxable income or stimulus payments such as Economic Injury Disaster Loans ("EIDL") grants, EIDL advances and certain Small Business Association (SBA) loan payments. Under Session Law 2021-180, these forgiven grants and forgiven loans - that are exempt from federal income taxation for 2020 - are also exempt from North Carolina taxation beginning in the year 2020.

So again, North Carolina taxpayers need to file amended tax returns if they picked up any these amounts in their 2020 taxable income.

C. Certain Unemployment Compensation Benefits are Excludable From Gross Income for Federal Tax Purposes for 2020

The first $10,200 of 2020 unemployment benefits were excludable from federal taxable income. Session Law 2021-180 required a North Carolina income tax "add back" for unemployment compensation benefits excluded from federal taxable income for the 2020 period.

In its Important Notice, the NCDOR advises that taxpayers should file amended returns for 2020 to **include** the unemployment compensation in their North Carolina taxable income if they otherwise failed to do so on their 2020 tax return. The NCDOR reminds taxpayers that they face late filing and late payment penalties, as well as statutory interest, if they fail to amend their 2020 returns.

D. Business Expenses and Federal Employee Retention Tax Credits. New NCGS 105-130.5(b)(11a) now allows for a **deduction** from federal taxable income for ordinary and necessary business expenses that were not deductible for federal tax purposes by virtue of employers claiming the Employee Retention Tax Credit for the same expenses. So, North Carolina allows for a deduction for those expenses, even when those expenses generate a Federal Employee Retention Credit.

E. Other Deductions for Certain North Carolina Sponsored Relief Programs. Under NCGS 105-130.5(b)(31a), beginning with the 2020 tax year, there are now deductions from federal taxable income for amounts received by a taxpayer for the following items:

(1) The Business Recovery Grant Program;

(2) RETOOLNC Grant Program; and

(3) Certain rent and utility assistance payments.

F. Effective Date. These changes are all effective as of January 1, 2020, so don't forget to amend those 2020 and 2021 tax returns.

PART FOUR
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. Federal Law. For Federal tax purposes, the Section 179 expense limit is $1 Million (adjusted for inflation) and the Federal Section 179 expense deduction is "phased-out" for annual purchases above $2 Million.

B. SB 276 Section 179 Limits and Phase-Out. Nevertheless, SB 276 (signed by Governor McCrory on June 1, 2016), provided for NC 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 NC 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).

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

A. 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).

III. 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. 105-134.6A(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. 105-134.6A(e). Also, under N.C.G.S. 105-134.6A(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."

And, remember that, under N.C.G.S. 105-134.6A(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. 105-134.6(A(d) and (e).

And finally, please note that, to the extent that the transferred asset has been fully depreciated, the basis addition will only benefit the transferee upon the sale of the asset. In other words, since the asset presumably has no more useful life left (since it has been depreciated to zero), the asset will not be subject to any future depreciation deductions.

B. Transfers of a Bonus Depreciation Asset After 2012. The NC 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. If the asset has no remaining life, then the basis adjustment will be completely recovered in the year of 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).

IV. 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 NCGS 105-153.6(e), then the husband could continue to take add back deductions for 5 years after the sale.

PART FIVE
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. Excess business interest deducted on federal return over thirty (30%) percent of taxable income limitation for North Carolina tax purposes;

7. Federal NOL carrybacks into 2013-2019 from the 2018, 2019 or 2020 tax years;

8. Federal excess NOL deduction against taxable income for 2018, 2019 and 2020;

9. Excess business loss deduction for federal purposes over business loss deduction for North Carolina purposes;

10. Federal qualified tuition and educational expense deductions; and

11. Amount of employer provided payment of education loans.

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

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

2. 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)

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

PART SIX
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.

Now that the Covid crisis may be nearing its end, it remains to be seen as to whether these employees go back to their employer's state of business or decide to continue to work remotely.

As this Part will discuss, there are many state tax issues that affect both the employer and the employee where those employees are working 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 a company where the only activity of that company 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 of Wayfair, may not provide any relief for the employer.

For example, assume that 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 use tax Nexus threshold during the pandemic where the pandemic has forced employees to work remotely in another state. However, the key word here is "temporarily" which means that once the pandemic is lifted, we may see those states reaching out to establish Nexus where a remote worker is living in that state and continues to work post pandemic.

B. 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 worker's 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 the situation where employees are working out of state remotely.

III. Concerns for the Employee.

For remote employees that work from home for an out of state employer, there are two 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, other than North Carolina, impose something called the "convenience of the employer" rule (Arkansas, Delaware, Nebraska, New York and Pennsylvania) 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. Other states, however, have not changed their rules and continue to dictate than an employee's withholding taxes are due to the location state of the employer regardless of where the employer worked post Covid.

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 you are deemed domiciled in New York, then New York taxes all of the New York resident'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 the taxpayer merely resides 183 days in that state even if that person is domiciled in another state.

Some states provide a tax credit for taxes paid on income earned in another state. However, 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. Likewise, 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, 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 rule.

The Convenience of the Employer Test. Some states also impose something called the "Convenience 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 a worker is domiciled in one state (e.g., NY) but works remotely in another state (e.g., Florida), the domiciliary (NY) state will subject the remote worker to taxation in that state (e.g., NY) if the worker worked remotely for his own his\her own convenience rather than out of mere necessity.

So, for example, a New York resident, who decides to work remotely out of their vacation condo in Florida, would be subject to New York tax 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. For example, in the example above, if the taxpayer 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 business necessity or business purpose 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 CPA Journal in the September 2021 issue written by Mark Klein, Joseph Endres and Katherine Piazza.

PART SEVEN
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. But, What About a Pass-Through Entity Deduction?

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 EIGHT
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 Important Notice.

Then, in April 2022, North Carolina issued "Important Notice Regarding North Carolina's Recently Enacted Pass-Through Entity Tax". On April 14, 2022, the NCDOR published a "Question and Answer" format explanation of how the new PTE deduction in North Carolina will work.

The Important Notice acknowledges there are many unanswered questions as to how the PTE rules in North Carolina will work in different fact situations. In various places, the Important Notice says that more guidance will be provided once North Carolina issues its instructions to 2022 tax returns.

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 needs to 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 anticipate recommending 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.

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 (currently at 4.99 percent). 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 2022 cannot be accrued, but instead the PTE will actually have to make the estimated tax payments in November and December of 2022 to generate a deduction in 2022, 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" are defined as:

(1) Individuals;
(2) Estates;
(3) Trusts "qualified" to hold S corporation stock; and
(4) Tax exempt entities.

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

VII. Estimated Tax Payment Requirements.

For 2022, PTE's are not required to make estimated income tax payments throughout the 2022 tax year. In the future, 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.

VIII. 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.

IX. 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 NCGS 105-153.6 - attributable North Carolina; **plus**

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

The adjustments mentioned in Section 105-153.6 relate to the decoupling adjustments required under NCGS 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. Net Losses

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 2022, 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 2022 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 2022 or the excess North Carolina tax payments made in 2022?

X. 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.

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.

XI. North Carolina Non-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.

XII. Treatment of Tax Credits.

There is some confusion as to how the credits themselves work. This is how we understand the rules to be:

A. Tax Credits in General.

The Important Notice also advises that a 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 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.

(4) A partnership does not make the PTE election in North Carolina but does make the PTE election in another state. In the case of a partnership, however, an individual North Carolina partner cannot claim the credit for the out-of-state tax paid by the partnership.

PART NINE
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. New Remote Sales Statute.

N.C.G.S. 105-164.8(b)(9) has been added to codify the SD-18-6 and the Wayfair decision. Now, this new subsection (b)(9) specifically provides 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. 2020 Changes to the Sales Tax Rules for Marketplace Facilitators.

NCGS 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 TEN
NORTH CAROLINA SALES AND USE TAX DEVELOPMENTS

I. NCDOR Publishes New Sales and Use Tax Bulletins.

The North Carolina Department of Revenue has published its updated Sales And Use Tax Bulletins based upon the sales tax laws in effect as of January 1, 2020. These bulletins supersede any Bulletins published prior to January 1, 2020.

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

A new section N.C.G.S. 105-164.4K has been 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 becomes 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.

III. New 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.

IV. New Legislative Grace.

Senate Bill 628 (2017) has added a new Section 105-244.3 to provide additional amnesty for certain taxpayers who make good faith mistakes and who otherwise intended to comply with all the RMI rules. This new Section is called the "Sales Tax Base Expansion Protection Act."

This Section now provides that the NCDOR shall **not** assess any tax for a filing period from March 1, 2016 through January 1, 2018 - if certain criteria are met, such as:

1. A retailer failed to charge sales tax on separately stated installation charges that were part of the sale of tangible personal property.

2. A person who failed to classify them as a retailer during 2016 and failed to charge sales tax on all retail transactions, but rather erroneously treated some transactions as real property contracts. Note, however, that the NCDOR can still assess any unpaid use taxes, on

purchases that were used by the retailer to fulfill a transaction that was erroneously treated as a real property contract.

3. A person who erroneously treated a transaction as a real property contract between March 1, 2016 and January 2018 and did not collect sales tax on the transaction that really was a retail sale or a taxable RMI service. (Note again, that the NCDOR can still assess unpaid use tax on any purchases that were used to fulfill the transaction that was erroneously treated as a real property contract).

4. A person who failed to collect sales tax on the retail sale of a service contract to maintain tangible personal property that has become part of real property between March 1, 2016 and January 2018.

Please note that there are other situations under new N.C.G.S. 105-244.3 that provide relief avenues available to taxpayers in other situations.

Note: Please also see: Important Notice: Sales Tax Expansion Protection Act, issued by the NCDOR on September 6, 2017.

V. 2018 Tax Changes to Sales Tax Amnesty Provisions.

N.C.G.S. 105-244.3 prohibited the NCDOR from assessing sales tax on certain specified transactions for filing periods before January 2018. The 2018 Appropriations Act amended N.C.G.S. 105-244.3(a) to extend the amnesty period **out another year to January 1, 2019**.

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.

VI. 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.

VII. Sales Tax Compromise Relief Expanded.

House Bill 97 and HB 1030 (2016) expand opportunities for potential tax compromise for "good faith efforts."

Prior to 2015, N.C.G.S. 105-237.1(a) provided that the DOR may agree to compromise a tax liability if the DOR determines that the tax compromise is "in the best interest of the State" and where there is a failure to pay or collect sales or use tax on admission charges or where there is a failure to pay or collect sales or use tax on the sale of a service contract.

The 2015 HB 97 (2015) amended N.C.G.S. 105-237.1(a)(6) to further expand the possible "good faith" compromise amnesty where the taxpayer failed to pay or collect sales or use tax on sales of tangible personal property sold to a real property contractor for use by the real property contractor in erecting structures, building on or otherwise improving, altering or repairing real property. The new "expanded amnesty" provisions under HB 97 became effective as of March 1, 2016.

The 2016 House Bill 1030 has further expanded the amnesty provisions of N.C.G.S. 105-237.1 by adding a new subsection (a)(7), which will allow the NCDOR to compromise a tax liability if the taxpayer failed to collect and pay sales or use tax as a result of the change in the definition of "retailer" or as a result of the sales tax base expansion to (i) service contracts, (ii) repair, maintenance and installation services or (iii) sales transactions for a person engaged in retail trade. New N.C.G.S. 105-237.1(a)(7). The new subdivision (7), however, makes it clear that this amnesty provision only applies where the taxpayer made a "good faith effort to comply with the sales and use tax laws."

This new subdivision (7) applies for tax assessments for any periods between March 1, 2016, and December 31, 2022.

VIII. Sales Tax Compromise.

The NCDOR has the authority to compromise the taxpayer's liability for failure to properly collect sales and use taxes on admissions and service contracts as long as the taxpayer made a good faith effort to comply with the law. This provision was set to expire for assessments issued after July 2020. However, under the 2018 Appropriations Act, the Department continues to have the authority to compromise any tax liability for any period ending before July 1, 2020, regardless of when the assessment was actually made. N.C.G.S. 105-237.1(a)(6).

PART ELEVEN
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. 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.

IV. 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).

V. 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).

VI. 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).

VII. 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.

VIII. North Carolina Important Notice: Impact of Market Based Sourcing on Pre-2020 Private Letter Rulings (February 1, 2020).

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.

IX. Corporate Tax Changes to the Definition of "Apportionable" Income.

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.

Note: 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 TWELVE
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. NCGS 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 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 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 THIRTEEN
OFFICE OF ADMINISTRATIVE HEARINGS DECISIONS

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

In McCabe, the NCDOR questioned:

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

(2) 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.

II. NC 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.

III. 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 NC 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.

IV. 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.

V. 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 condition was indeed an enrolled agent).

VI. 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).

VII. 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 NC 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 NC 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".

VIII. 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.

IX. 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 NCGS 105-236(a)(5)(b) for understating her income by 25% or more. Under NCGS 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 NC 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 FOURTEEN
NORTH CAROLINA DEPARTMENT OF REVENUE PROCEDURAL CHANGES

I. 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.**

II. 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.

III. 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.

IV. 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.

V. 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. Under the amended N.C.G.S 105-163.3, effective January 1, 2020, a payer must deduct and withhold 4% NC 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 NC 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.

VI. Recognizing Powers of Attorney

The General Assembly has 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. The North Carolina Department of Revenue is supposed to give the General Assembly a status report on how it is progressing with this project by January 31, 2020. Session Law 2019-246 (November 8, 2019).

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. Contingent Event Claims. 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. Event Or Condition Other Than A Contingent Event. 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".*

X. North Carolina Volunteer Disclosure Program.

A. Background. The North Carolina Volunteer Disclosure Program is designed to promote compliance and to benefit taxpayers who discover a past filing obligation and liability that has not been discharged. It applies to taxpayers who have failed to file returns and pay any tax due to the North Carolina Department of Revenue. It also applies to any tax administered by the North Carolina Department of Revenue, as well as any type of domestic or foreign taxpayer who is subject to tax in North Carolina.

However, this program is not available to corporate and individual income taxpayers who have engaged in income shifting tax strategies or other tax shelter activities that minimize or eliminate North Carolina state taxes. Also, the voluntary disclosure program does not apply to any taxpayer who is registered for payment of the tax but fails to file a return (ex. sales or employment tax returns), and it does not apply to a taxpayer who files a return but under reports tax due on the return.

Voluntary disclosure arises when a taxpayer contacts the North Carolina Department of Revenue without any prior initial contact by the North Carolina Department of Revenue concerning the filing of a return and the payment of a tax. Voluntary disclosure includes requests by taxpayers under the Multistate Tax Commission National Nexus Program. A major component of the Voluntary Disclosure Program is to resolve sales and use tax, and corporate income and franchise tax liabilities when nexus is the central issue.

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

Description of Program

The North Carolina Voluntary Disclosure Program (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.

I. 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.

II. 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.

III. 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

IV. 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.

V. 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.

VI. 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.

VII. Any Questions?

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

PART FIFTEEN
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) is 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.

III. 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.

IV. 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. NCGS 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 has 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 have 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