FALL 2013

NORTH CAROLINA STATE AND LOCAL TAX UPDATE

Keith A. Wood, Attorney, CPA
Carruthers & Roth, P.A.
235 N. Edgeworth Street
Post Office Box 540
Greensboro, NC 27402
Phone: (336) 478-1185
Fax: (336) 478-1184
kaw@crlaw.com

******************************************************************************

Keith Wood, CPA, JD, an attorney with Carruthers & Roth, PA, in Greensboro, NC, is certified by the North Carolina State Bar as a board certified specialist in estate planning and probate law. Keith's practice areas include tax planning and representation of clients before the Internal Revenue Service, corporate law and business transactions, and personal estate planning. Keith is a frequent speaker to civic and professional groups on business planning, taxation, and estate planning, and has authored published articles on these topics.

Keith received his undergraduate degree in Business Administration and his Law Degree, with Honors, from the University of North Carolina. While in law school, Keith served as the business manager of the North Carolina Journal of International Law and Commercial Regulation.

Keith also is an active member of NCACPA and a former member of its Board of Directors.

Keith and his wife, Jody, live in Greensboro with their two children, Edie and Xander.
Introduction

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

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

Please note that this manuscript went to print on October 14, 2013, and therefore this manuscript may not include all of the most recent North Carolina Department of Revenue pronouncements or court cases.
PART ONE

NORTH CAROLINA "DECOUPLES" FROM SOME OF THE PROVISIONS OF THE FEDERAL AMERICAN TAXPAYER RELIEF ACT OF 2012


As we know, on January 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012, which retroactively extended a number of expiring tax provisions. Then, on March 13, 2013, Governor McCrory signed House Bill 82 which adopted some, but not all, of the expiring federal tax provisions.

Here are some of the federal tax provisions that were not extended by HB 82 into 2013, and thus were "de-coupled" from the Federal Tax Act for North Carolina tax purposes beginning in 2013:

1. No Federal Section 222 deduction for qualified tuition expenses beginning in 2013. See amended N.C.G.S. 105-134.6(c));

2. No Section 108 COD exclusion for discharged qualified principal residence debt beginning in 2013. (See amended N.C.G.S. 105-134.6(c));

3. No deduction for mortgage insurance premiums beginning in 2013. (See amended N.C.G.S. 105-134.6(c));

4. North Carolina Earned Income Credit reduced from 5% to 4.5% of Federal Section 32 credit beginning in 2013. (See amended N.C.G.S. 105-151.31);

5. North Carolina Adoption Credit reduced from 50% to 30% of Federal Section 36C adoption credit beginning in 2013. (See amended N.C.G.S. 105-151.32); and

6. Work Opportunity Tax Credit Reduced to 3% of Federal Credit beginning in 2013. (See amended N.C.G.S. 105-129.16G).
II. **No North Carolina Section 168 Bonus Depreciation: HB 82 (Session Law 2013-10, March 13, 2013) and HB 14 (Session Law 2013-414, August 23, 2013).**

A. **Federal Law.** The American Taxpayer Relief Act of 2012 extended the 50% Section 168 Bonus Depreciation for 2013. However, the Federal bonus depreciation rules are scheduled to expire on December 31, 2013, although there is always the possibility that the Federal bonus depreciation rules will be extended.

B. **HB 82 “De-couples” Bonus Depreciation from the Federal Act.** Regardless, on March 13, 2013, Governor McCrory signed House Bill 82 which did not adopt the federal bonus depreciation rules for North Carolina tax purposes. So, for 2013 and beyond, the North Carolina rules mandate an 85% "add back" for 2013 with 20% "add back" deductions over the next five (5) years beginning in 2014. See amended N.C.G.S. 105-130.5(a)(15b); N.C.G.S. 105-130.5(b)(21b); N.C.G.S. 105-134.6(c)(8b) and N.C.G.S. 105-134.6(b)(17b).

C. **Bonus Depreciation Deductions of a Transferor Can Be Added to Tax Basis of Transferee.** In addition, 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 new N.C.G.S. 105-130.5B(e) (applicable to corporations) and under 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 a "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.

D. **Bonus Depreciation Add Back for Prior Transactions.** And finally, with respect to transfers of bonus depreciation assets before 2013, the transferee (again in a non-recognition event) can make an election to make the basis adjustment allowed under N.C.G.S. 105-135.6(c) on the transferee's 2013 tax return to the extent that the transferor has not taken the bonus depreciation deductions on a prior return and provided that the transferor certifies in writing that the transferor will not take any future bonus depreciation deductions. **Again, this election must be filed with the transferee's 2013 tax return.**


III. **New Section 179 Limitations for 2013 and Beyond: HB 14 (Session Law 2013-414, August 23, 2013).**

A. **Federal Law.** For Federal tax purposes, the Section 179 expense limit is $500,000 for 2013, and $25,000 for 2014. And, the Federal Section 179 expense deduction is "phased-out" for annual purchases between:

- $2 Million and $2.5 Million for 2013
- $200,000 and $225,000 for 2014

B. **HB 14 New Section 179 Limits and Reduced Phase-Out.** Under HB 14 (signed by Governor McCrory on August 23, 2013), there are new Section 179 limitations and a reduced phase-out threshold beginning in 2013 for North Carolina tax purposes.

1. **New North Carolina Section 179 Limits and Phase-Outs.** The new North Carolina Section 179 limit is $25,000 beginning in 2013. New N.C.G.S. 105-130.5B. And, the Section 179 deduction will be "phased-out" for annual acquisitions between $125,000 and $150,000 beginning in 2013. N.C.G.S. 105-130.5B(c).

2. **North Carolina 85% Add-back and Subsequent Year 20% Deductions.** So, beginning in 2013, North Carolina 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).
I. **Individual Income Tax Changes: HB 998 The Tax Simplification Act (Session Law 2013-316, July 23, 2013).**

On July 23, 2013, Gov. McCrory signed HB 998, The Tax Simplification Act, which made a number of significant changes to the North Carolina individual income tax system. For the most part, these changes will not go into effect until 2014.

A. **Flat Tax Rates, No More Personal Exemption Amounts, and Increased Standard Deduction Amounts.**

1. **New Flat Tax Rates Replace Old Graduated Tax Rates:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>Graduated rates range from 6% to 7.75%</td>
</tr>
<tr>
<td>2014</td>
<td>5.8%</td>
</tr>
<tr>
<td>After 2014</td>
<td>5.75%</td>
</tr>
</tbody>
</table>

New N.C.G.S. 105-153.7.

2. **The Personal Exemption is Repealed After 2013.** Beginning in 2014, the $2,000 - $2,500 personal exemption amounts allowed under N.C.G.S. 105-153.5(a) are repealed.

3. **New Increased Standard Deduction Amounts.** Although HB 998 eliminates the standard deduction "add-ons" for age and blindness, HB 998 provides for increased standard deduction amounts as follows beginning in 2014 for taxpayers who do not itemize their deductions:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard Deduction</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Single</td>
<td>$3,000</td>
<td>$7,500</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>$3,000</td>
<td>$7,500</td>
</tr>
<tr>
<td>Married filing jointly</td>
<td>$6,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Head of Household</td>
<td>$4,400</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

New N.C.G.S. 105-153.5(a)(1).
B. **New Deduction Limits for Taxpayers Who Itemize on Federal Return.**

Taxpayers who itemize their deductions for federal tax purposes will now be **limited** to the following itemized deductions for North Carolina tax purposes beginning in 2014:


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.

C. **Some AGI Reductions From Federal AGI Are Retained, And Others Are Eliminated, Beginning in 2014 Under New N.C.G.S. 105-153.5(b).**

1. **Some North Carolina Subtractions from Federal AGI that are retained for 2013 and thereafter are as follows:**
   a. Interest income from U.S. and North Carolina debt obligations. N.C.G.S. 105-153.5(b)(1);
   b. Social Security and Railroad Retirement Benefits. N.C.G.S. 105-153.5(b)(3);
   c. 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);
   d. State and local income tax refunds. N.C.G.S. 105-153.5(b)(4);
   e. 20% deduction allowed due to the Section 168 or Section 179 "add back." N.C.G.S. 105-153.5(b)(8); and
   f. 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).

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

2. **So, the following North Carolina deductions from Federal AGI are eliminated beginning in 2014 (but remain for 2013):**
   a. $50,000 non-passive business income deduction;
   b. $4,000 deduction for governmental retirement plan benefits paid to governmental retirees (except those exempt under Bailey, Emory and Patton cases);
   c. $2,000 deduction for qualified private retirement plan distributions;
d. $35,000 deduction for severance wages paid upon an involuntary termination of employment;

e. reduction for amounts added to federal AGI where the taxpayer claims a credit rather than a deduction on the federal tax return; and

f. deduction for amounts contributed to a North Carolina 529 Educational Savings Account.

D. Additions To Federal AGI Are Retained For 2014 And Thereafter. Here are some of the Federal AGI additions that apply for 2014 and thereafter:

1. Interest income from debt obligations of states other than North Carolina. N.C.G.S. 105-153.5(c)(1);

2. The Federal Section 199 production activity deduction for federal tax purposes. N.C.G.S. 105-153.5(c)(4);

3. 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);

4. 85% "add back" for excess Federal Section 179 and Section 168 deductions. N.C.G.S. 105-153.5(c)(5); and

5. 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).

E. Personal Income Tax Credits Repealed or Allowed to Expire. H.B. 998 repealed a number of North Carolina tax credits. In addition, HB 998 allowed to expire a number of tax credits that were already scheduled to expire after 2013.

1. Here are some of the North Carolina tax credits repealed by HB 998 beginning in 2014:

   a. the dependent child care credit;
   b. credits for conservation easements;
   c. credits for the disabled;
   d. credits for charitable contributions by taxpayers who do not itemize; and
   e. credits for educational expenses for children with special needs.
2. Here are some of the North Carolina tax credits that were already scheduled to expire after 2013 that were not extended under HB 998:

a. credit for adoption expenses;
b. credit for long-term care insurance;
c. earned income credit; and
d. the qualified business venture credit.

Evidently, in the absence of North Carolina legislation to extend these credits, these credits will "sunset" at the end of 2013.


A. Background. Under N.C.G.S. 105-134.6(b)(22), there is a personal income tax net business income tax deduction equal to $50,000 of net "business income" received during the year. And, if both spouses receive business income during the year, the maximum dollar amounts apply separately, so the married couple can deduct up to $100,000 of net business income for North Carolina tax purposes. The term "business income" does not include income that is considered "passive" under the federal tax code.

B. In June 2012, NCDOR Issues a Directive to Interpret the $50,000 Individual Income Tax Deduction for Net Business Income. In its Directive dated June 11, 2012 (No. PD-12-2), the NCDOR issued a Directive interpreting the new "Net Business Income Tax Deduction" for North Carolina income tax purposes. The Directive was presented in a "frequently asked questions" (FAQ) format and provides some guidance on how the new Net Business Income deduction will operate.

In this Directive, the Department of Revenue made the following observations:

1. S Corporation Wages Are Not "Business Income" of an S Corporation. First, the Directive states that, for purposes of determining the net business income of an S Corporation, wages paid to the S Corporation owners are not considered to be net business income.

Example: The taxpayer is a 25% shareholder of an S corporation from which he receives non-passive income. The taxpayer reports $25,000 of the non-passive income on his Schedule E resulting from $25,000 of ordinary income as shown in his Form 1120-S K-1. The $25,000 is the shareholder's portion of the $240,000 total S corporation income less $140,000 of wages paid to the S Corporation owner and to others (S corporation net income of $100,000).

Answer: In this example, the total non-passive income of the S Corporation is $100,000 ($240,000 total income minus $140,000 of wages). In this example, the taxpayer may claim a net business income tax deduction of only $25,000, even though the S Corporation shareholder also received wages from his S Corporation.
Note: In other words, the wages paid to the S corp shareholder by the S corporation will not count as "net business income."

2. Next, the Directive advises that all of the taxpayer's net business income and net business losses must be aggregated before determining the net business income tax deduction for the year.

Example: The Taxpayer reports a net profit of $60,000 from a non-passive business activity on his federal Schedule C and a partnership loss of $70,000 from a non-passive business activity on his federal Schedule E. Is the taxpayer entitled to any net business income deduction?

Answer: No. If non-passive losses exceed non-passive income, the taxpayer is not entitled to any net business income deduction for the year.

3. However, the Directive also provides that non-passive income from one spouse is not reduced by the non-passive loss of the other spouse.

Example: Taxpayers are a married couple filing jointly. Mr. Taxpayer reports a net loss of $60,000 from a non-passive business activity on his federal Schedule C and Mrs. Taxpayer reports partnership income of $70,000 from a non-passive business activity on Schedule E. Are the taxpayers entitled to a deduction?

Answer: Here, the Department advises that the Taxpayers may claim a net business income deduction of $50,000 against Mrs. Taxpayer's non-passive partnership income. That is because the maximum dollar amount of the deduction is applied separately to each spouse. So in this example, although Mr. Taxpayer suffered a loss from a non-passive activity, the Taxpayers may claim a net business income tax deduction of $50,000 against the non-passive income from Mrs. Taxpayer's partnership income. In other words, Mr. Taxpayer's sustained net loss is not offset against Mrs. Taxpayer's non-passive income.

4. Fourth, the Directive again advises how the $50,000 maximum dollar amount deduction is applied separately to non-passive income for each spouse of two spouses filing a joint return where both spouses have non-passive income.

Example: Taxpayers are a married couple filing jointly. Mr. Taxpayer reports a net profit of $20,000 for non-passive business activity on his federal Schedule C and Mrs. Taxpayer reports a net profit of $60,000 from an unrelated non-passive business activity on federal Schedule C.
Question: What deductions are available to the taxpayers?

Answer: The answer is that the taxpayers are entitled to claim a net business income deduction of $70,000 ($20,000 for husband and $50,000 for wife).

5. And finally, the Directive also makes it clear that married taxpayers may be entitled to net business income tax deductions for non-passive income generated through the same pass-through business entity.

Example: Taxpayers are a married couple filing jointly. Mr. Taxpayer owns 60% of a single pass-through entity and Mrs. Taxpayer owns the other 40%. Mr. Taxpayer reports $60,000 of non-passive income from the pass-through activity and Mrs. Taxpayer reports $40,000 of income from the pass-through entity on federal Schedule E.

Question: What is the deduction available to the taxpayers?

Answer: The answer here is the taxpayers are entitled to claim a net business deduction of $90,000 ($50,000 for husband and $40,000 for wife).


C. North Carolina Department of Revenue Issues New 2013 Directive Regarding the $50,000 Business Income Deduction for 2012 and 2013. On March 28, 2013, the North Carolina Department of Revenue issued a new "Questions and Answers" release to supplement its prior June 2012 Directive, PD-12-2. Although the $50,000 business income deduction is repealed after 2013, this "Q&A Release" provides some notable guidance as we continue to wrestle with ongoing issues for 2012 and 2013.

Below is a reproduction of the North Carolina Department of Revenue Release from March 28, 2013:

Frequently Asked Questions Regarding the Deduction for Net Business Income

This document supplements Directive PD-12-2 and addresses questions received subsequent to that Directive.

1. If an individual is classified as a statutory employee on their W-2, can that individual claim the net business income deduction?

   o A statutory employee reports all items of income and expense for the related activity on federal Schedule C. If the individual reports a net profit from the activity, they may claim the deduction for net business income for the lesser of the Schedule C net profit (rather than the amount shown on the W-2) or $50,000.
2. A self-employed individual cuts hair in a shop and pays for booth rental. That individual receives from the operator of the shop a Form 1099 that shows income earned of $30,000. What net business income deduction is this individual entitled to claim?

   o This individual must report the $30,000 as income and may claim expenses for the related activity on federal Schedule C. If the individual reports a net profit from the activity, they may claim the deduction for net business income for the lesser of the Schedule C net profit (rather than the amount shown on the Form 1099) or $50,000.

3. If there is a passive activity with losses that are carrying forward and there is a complete disposition of that passive activity, under IRC 469(g) the carried-forward losses are treated as “not from a passive activity.” In this situation, if the taxpayer also has substantial nonpassive business income, would those freed-up passive losses count against him and offset his nonpassive business income, thereby reducing or eliminating the North Carolina business deduction of up to $50,000?

   o For purposes of this deduction, passive income means the income generated from the conduct of an activity of a trade or business that satisfies the definition in IRC section 469. Likewise, a passive loss means the loss generated from the conduct of an activity of a trade or business that satisfies the definition in IRC Section 469. Treasury Regulation §1.469 provides official interpretation on when income or loss is considered passive. We follow the treatment of classifying income or loss as passive or nonpassive based on this treasury regulation and IRC Section 469. Because IRC Section 469(g) treats the disposition of the entire interest in a passive activity as “a loss which is not from a passive activity,” the loss must be offset against any current nonpassive business income in determining the North Carolina business deduction available.

4. Are capital gains subject to the net business deduction on the North Carolina return?

   o Capital gains or losses are not considered in determining the net business deduction.

5. The taxpayer has net business income of $30,000 from an S corporation in which he materially participates under IRC 469. He also has an LLC that owns a commercial building. The commercial building is leased 100% to the S corporation that he owns. The LLC produces net rental income of $5,000. Under IRC Reg 1.469-2(f)(6), the net rental activity income from property is treated as not from a passive activity if the property is rented for use in a trade or business activity in which the taxpayer materially participates. What is the amount of the North Carolina business deduction?
6. An individual had the following items of income and deductions on his federal income tax return: Business income of $40,000 subject to self employment tax, a deduction of $1,700 for self employment tax, a deduction of $2,000 for self employed Simplified Employee Pension (SEP) plan, and a deduction of $3,000 for self employed health insurance. What is the amount of the NC Small Business Deduction?

   o The business deduction is not limited to Small Businesses. This individual may claim a North Carolina business deduction of $40,000, presuming the business income is nonpassive income. Adjustments to income have no impact on determining the business deduction.

7. An individual had nonpassive business income of $30,000 and an addition to adjusted gross income on the North Carolina return of $6,000 for section 179 expense claimed on the federal return. What is the amount of the business deduction?

   o This individual may deduct $30,000 as a business deduction on the North Carolina individual income tax return. Additions to adjusted gross income on the State return are not considered in determining the business deduction.

8. An individual had nonpassive business income of $30,000 and a deduction from adjusted gross income on the North Carolina return of $6,000 for bonus depreciation. What is the amount of the business deduction?

   o This individual may deduct $30,000 as a business deduction. Deductions from adjusted gross income on the State return are not considered in determining the business deduction.

9. What is the North Carolina stance on part-year residents and the $50,000 business deduction? For example, if a taxpayer had $100,000 of income, $50,000 from Florida while a Florida resident and $50,000 from North Carolina while a North Carolina resident, does that individual get a $50,000, $25,000 or zero deduction? Does this change if the situation is a non-resident who has North Carolina business income?

   o Presuming that all of the $100,000 net business income included in federal adjusted gross income is not considered passive, the taxpayer is entitled to a $50,000 deduction. The $50,000 deduction will reduce both the numerator and the denominator of the fraction in computing the North Carolina proration percentage. For the part-year resident, the numerator includes income from all sources while a resident of the State and, during the period the individual is a non-
10. Can we confirm that the $50,000 business deduction applies to S-Corp K-1 income if it is not subject to self-employment tax?

- The K-1 for the S-Corp return (Form 1120-S) has no self-employment tax line similar to that on the K-1 (block 14 – self-employment earnings (loss)) of the Partnership return (Form 1065). Despite the fact this item is not included on the K-1 of the S-Corp, that income is subject to the $50,000 deduction unless this is passive income.

11. Please address the following situation: Husband owns an operating business, an S-Corp, from which he reports income of $60,000 on his federal return. He is clearly nonpassive with regard to this business. Wife may or may not have ownership, but does not work there. There is also an LLC which rents real estate to the operating business, owned 50/50 by husband and wife. The income of $10,000 from the rental LLC is clearly nonpassive with regard to the husband under the self-rental rule (see 1.469-2(F)(6)). But how is the rental LLC treated for the spouse? Keep in mind that under IRC 469, the passive/nonpassive determination for a married couple is made jointly. Thus, she is also nonpassive under IRC 469 with regard to the rental LLC because he is nonpassive under the self-rental rule. It would seem that the spouse is eligible for a business income subtraction in this case, but clarification here would be appreciated.

- Taxpayers may claim a business deduction of $55,000 on their joint return. ($50,000 for husband and $5,000 for wife)

12. Under Reg. 1.469-4(d)(1), an operating business can in certain situations be grouped with a rental activity, potentially converting the rental income or loss from passive to nonpassive. Will the federal treatment under this Regulation be followed for the North Carolina business income deduction?

- Treasury Regulation §1.469 provides official interpretation on when income or loss is considered passive. We follow the treatment of classifying income or loss as passive or nonpassive based on this treasury regulation and IRC Section 469.


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

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

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

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

Note: A North Carolina taxpayer is required to carry back a 2008 NOL to the same year for federal and state income tax purposes. N.C. Department of Revenue Announcement, August 14, 2009.
C. **New 2010 North Carolina Legislation.** Governor Perdue signed Senate Bill 897 on June 30, 2010, which updates the North Carolina references to the IRS Tax Code as of May 1, 2010. N.C.G.S. 105-228.90(b)(1b). However, Senate Bill 897 also requires certain adjustments to the federal taxable income. Under new N.C.G.S. 105-135.6(d)(7), a North Carolina taxpayer (other than an ESB) is required to add back, to federal taxable income, the amount of any 2008 or 2009 NOL claimed under the WHBAA beyond the standard 2 year carryback period. However, no addition to federal taxable income is required for the portion of a NOL that is attributable to an ESB as defined by § 172(B)(1)(H) of the IRS Tax Code. So, only North Carolina ESBs can utilize the benefits of 2008 NOLs and 2009 NOLs more than 2 years.

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

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

SB 897, effective June 30, 2010.

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

IV. **No Deduction for Unsubstantiated Charitable Contributions.** Secretary of Revenue Decision No. 2006-268, North Carolina Department of Revenue, February 7, 2007. Deductions Claimed for a Taxpayer's Cash and Non-cash Charitable Contributions to a Church Were Disallowed Because the Taxpayer Failed to Provide Adequate Substantiation.

In this case, the Taxpayer timely filed his North Carolina individual income tax returns for the tax years 2002, 2003 and 2004. For the years at issue, Taxpayer claimed the following deductions for charitable contributions on his income tax returns:

<table>
<thead>
<tr>
<th>Deductions</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Contributions</td>
<td>$9,500.00</td>
<td>$11,100.00</td>
<td>$11,000.00</td>
</tr>
<tr>
<td>Noncash Contributions</td>
<td>$3,300.00</td>
<td>$3,200.00</td>
<td>$2,950.00</td>
</tr>
<tr>
<td>Total</td>
<td>$12,800.00</td>
<td>$14,300.00</td>
<td>$13,950.00</td>
</tr>
</tbody>
</table>
The examining auditor requested verification of the charitable contributions for the tax years 2002, 2003 and 2004 from Taxpayer. Because the Taxpayer did not submit factual evidence to verify the contributions, the examining auditor disallowed the contribution deductions for each year.

The Taxpayer contended that he contributed at least thirty percent (30%) of his salary each week to a church, although he was not a member of a church and did not use church envelopes. The Taxpayer also submitted copies of hand written statements showing cash contributions given to a particular church each week for the tax years 2002, 2003 and 2004. The Taxpayer believed that these hand written statements were acceptable documentation.

However, the Taxpayer was unable to provide an acknowledgment from the church for any contributions. Although requested to do so, the Taxpayer did not furnish reasonable or reliable documentation to verify the contributions claimed on his tax returns. So, all of the charitable contribution deductions were disallowed.

V. **Bad Debt Deduction Disallowed For Shareholder Who Made Loans to His Corporation; Sec. of Rev. Decision 2007-199.**

In Secretary of Revenue Decision 2007-199 (December 5, 2007), the North Carolina Department of Revenue disallowed a bad debt deduction for worthless loans made by a taxpayer to his start-up corporation. The Secretary of Revenue ruled in favor of the NC DOR on the following basis:

1. The loan made by the taxpayer to his start-up corporation was not a loan, but was a contribution to capital; and

2. The debt had not become worthless in the year the loss was claimed.

In this case, that taxpayer contended that, when he made the loan to his closely-held corporation, he intended that the loans would be repaid from the corporation's future profits. However, the Secretary of Revenue found that the taxpayer did not anticipate being repaid - unless the corporation's business profits were sufficient to pay other creditors. According to the Secretary of Revenue, this arrangement did not reflect a true loan arrangement, since a bona fide lender would not make business loan without a firm expectation of repayment. Moreover, although the loan documentation provided for payments of interest, the corporation never actually made any payment of interest or principal on the loan.

The Secretary of Revenue also determined that, even if the capital contributions could be recharacterized as loans, the loans had not become worthless in the year the bad debt deduction was claimed. Although the taxpayer contended that the business had suspended its operations, the corporation had not dissolved or filed bankruptcy, and therefore the corporation was still viable as a going concern. Thus, the debt had not become worthless in the year that the bad debt deduction was claimed.
VI. No Personal Income Tax Deductions Allowed for "Hobby Losses" Relating to Dog Breeding/Showing Activity.

A. **Introduction.** Secretary of Revenue Decision 2007-101 (December 6, 2007) involved a taxpayer who claimed losses on her North Carolina tax returns for her dog breeding/showing activities.

In this case, for 2002 and 2003, the taxpayer filed Federal Schedules C for her interior design business and for her dog breeding/showing activity. During these two tax years, the taxpayer's principal source of income was from her interior design business.

Upon audit, the Department of Revenue disallowed the Schedule C losses relating to the dog breeding/showing activities on the basis that the taxpayer was not able to show that the activity was engaged in "for profit" in accordance with Section 183 of the Internal Revenue Code.

B. **General Section 183 “Hobby Loss” Rules.**

1. **Background.** Section 183 denies any deductibility of losses or expenses incurred in connection with a hobby rather than a trade or business. Section 183(a) provides that, if an individual or an S Corporation is engaged in an activity that is not engaged in for profit, no deduction attributable to the activity shall be allowed. Section 183(c) defines an activity “not engaged in for profit” as any activity other than one with respect to which deductions are allowable for the tax year under Section 162 or Section 212. Deductions are allowable under Section 162 or Section 212 only where the taxpayer is engaged in an activity with an actual and honest objective of making a profit.

2. **“Three-out-of Five Year” Rule.** Section 183(d) provides that an activity will be presumed to be an activity "engaged in for profit" if income exceeds deductions in three out of five consecutive taxable years.

3. **Facts and Circumstances Test.** Finally, Treas. Reg. 1.183-2(b) lists some of the factors to be considered in determining whether an activity is engaged in for profit. The factors listed include:

   1. the manner in which the Taxpayer carries on the activity;
   2. the expertise of the Taxpayer or his advisors;
   3. the time and effort expended by the Taxpayer in carrying on the activity;
   4. the expectation that the assets used in the activity may appreciate in value;
   5. the success of the Taxpayer in carrying on other similar or dissimilar activities;
6. the Taxpayer's history of income or losses with respect to the activity;
7. the amount of vocational profits, if any, which are earned;
8. the financial status of the Taxpayer; and
9. the involvement of elements of personal pleasure or recreation.

C. N.C. Secretary of Revenue Decision 2007-101. Indeed, there were many factors which indicated that the dog breeding/showing activities were not engaged in "for profit." For example, the taxpayer could not provide receipts and invoices which substantiated the amount of income or expense amounts claimed on the federal Schedule C for the dog breeding/showing activities. The taxpayer also used the same checking account to pay for expenses for her interior design services and for her dog breeding/showing activities. Also, the taxpayer's records were not organized and the North Carolina Department of Revenue auditor was not able to distinguish between the personal versus potential business expense.

Moreover, the taxpayer did not maintain records to track income and expenses attributable to any dog. There were no accounting books for this activity that would allow the taxpayer to analyze profit potential of the activity so as to make an informed decision regarding its profitability.

Also, the taxpayer did not develop a business plan for her dog breeding/showing activity. The taxpayer could not prove how much time and effort was put into the dog breeding/showing activity.

Although the taxpayer was a member of various dog kennel clubs and attended classes on grooming and handling dogs, she had not been successful in a similar activity in the past and she could not prove that she was undertaking any ongoing analysis efforts to determine how she ultimately would be able to turn her dog breeding/showing activity into a bona fide "for profit activity."

Although the taxpayer stated that she intended to make a profit on her activities, she was not able to furnish any meaningful projections showing how she could ever reasonably expect to make any such profits. Also, the taxpayer could not prove that losses reported were due to circumstances beyond her control.

Ultimately, in this case, the taxpayer could not prove to the North Carolina Department of Revenue that she was engaged in the dog breeding/showing activity for profit.

Note: Also note that a ten percent (10%) North Carolina negligence penalty was also assessed.
VII. **When is a Person a Resident of North Carolina?**

In Fowler v. NC Department of Revenue, 11 REV. 14832 (July 17, 2013), the Secretary of Revenue determined that the Fowlers had not abandoned North Carolina as their domicile nor had they adopted Florida as their new domicile. As a result, the Fowlers owed a significant amount of income tax from the sale of their closely-held business despite their attempts to “move” to Florida.

Here are the facts of that case:

In the 1990s, Mr. and Mrs. Fowler began considering Florida as a potential retirement location. Mr. Fowler was born and raised in North Carolina and a significant amount of his family lived in North Carolina. Mr. Fowler had no family in Florida. Up through 2005, Mr. Fowler had spent his entire lifetime as a North Carolina resident. Mrs. Fowler likewise was born and raised in North Carolina.

In 2002, Mr. and Mrs. Fowler purchased a three bedroom 3,400 square foot home in Naples, Florida. In April 2003, Mr. and Mrs. Fowler moved from Apex, North Carolina to Raleigh, North Carolina. From 2003 to 2005, Mr. and Mrs. Fowler's primary residence was their residence in Raleigh and their secondary residence was their home in Naples, Florida.

The Raleigh home was a 2,800 square foot one bedroom home and also had two (2) 30,000 square foot garages. The total cost to construct the Raleigh home was around $2.8 Million.

In early 2005, Mr. Fowler hired an investment banking firm to assist him in the eventual sale of his highly successful business. In early 2006, Mr. Fowler sold 60% of his business to a private equity firm, but retained a 33% ownership interest and agreed to continue to manage the day-to-day business operations of the business.

Pursuant to the terms of his Employment Agreement dated February 3, 2006, Mr. Fowler agreed to continue to serve as President of the business and continued in that role until February 2009. Closing on the sale of Mr. Fowler's stock in the business occurred on February 3, 2006 and the purchase funds were wired into his account on that same date.

In early 2006, the Fowlers began their attempts at establishing domicile in Florida, by attempting to obtain a Florida drivers license, by signing a Declaration of Domicile in Florida and by changing their records to reflect their Florida address. Mr. Fowler signed a Florida Homestead Exemption application indicating that he was a Florida resident on March 10, 2006. On March 10, 2006, Mr. and Mrs. Fowler obtained Florida drivers licenses and registered to vote in Florida. Mr. Fowler ultimately signed a Declaration of Domicile on March 10, 2006.

However, the Fowlers retained their Raleigh home so that Mr. Fowler would have a place to stay while in North Carolina. The Fowlers ultimately did not list the Raleigh home for sale until December 2010.
During 2006 and 2007, Mr. and Mrs. Fowler spent a majority of their days during those years in North Carolina. And, the Fowlers were never able to prove that they spent at least 183 days in Florida in either 2006 or 2007.

There was also additional evidence, introduced by the Secretary of Revenue at the Hearing, indicating that Mr. and Mrs. Fowler continued to be North Carolina residents. For example, they used their North Carolina residence address on various business license documents; they made charitable contributions to North Carolina charities and they kept North Carolina drivers licenses and vehicle registrations in North Carolina. Also, the Fowlers continued to use their North Carolina physicians.

Ultimately, the Secretary of Revenue concluded that, although Mr. and Mrs. Fowler may have intended to retire in Florida one day, the facts demonstrated that the Fowlers (i) never abandoned North Carolina as their domicile, (ii) never adopted Florida as their domicile, and (iii) never intended to make Florida their permanent home. Therefore, all of the income from the sale of their business in 2006 was subject to North Carolina income tax.

VIII. **New NCDOR Directive Addresses North Carolina Filing Status For Same-Sex Married Couples.**

On October 18, 2013, the North Carolina Department of Revenue issued Directive PD-13-1 to address the impact, for purposes of North Carolina taxation, of IRS Revenue Ruling 2013-17.

In Revenue Ruling 2013-17, the IRS advised that it would allow same-sex spouses to file their federal income tax returns using the filing status of "married filing jointly" or "married filing separately." However, because under N.C.G.S. 51-1.2, North Carolina does not recognize same-sex marriages as valid, the NCDOR cannot follow Revenue Ruling 2013-17.

So, individuals who enter into a same-sex marriage in another state cannot file a North Carolina income tax return using the tax status of "married filing jointly" or "married filing separately." Instead, each such individual will need to file a separate North Carolina income tax return on Form D-400 using the filing status "single" (or "head of household" if so qualified). And, if the individuals filed a federal tax return as "married filing jointly" or "married filing separately," they must then complete a separate pro forma federal return using the filing status "single" (or "head of household" if appropriate) to determine each individual's proper adjusted gross income, deductions and tax credits allowed for federal tax purposes and then must attach a copy of the federal pro forma return to the North Carolina tax return.
PART THREE
ESTATE AND TRUST TAX DEVELOPMENTS


HB 998 repeals the North Carolina estate tax retroactively effective as of January 1, 2013. This means that, for North Carolina residents dying after December 31, 2012, there will be no North Carolina estate tax owed.

II. North Carolina Income Taxation of Foreign Trusts With North Carolina Beneficiaries.

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

B. Kaestner Trust. Nevertheless, on February 11, 2013, the North Carolina Business Court denied the North Carolina Department of Revenue's motion to dismiss claims that such taxation is unconstitutional under the Due Process Clause and the Commerce Clause of the United States Constitution and the North Carolina Constitution where the only connection of a foreign trust to North Carolina is the North Carolina residence of the trust's discretionary trust beneficiaries. The Kimberly Rice Kaestner 1992 Trust v. North Carolina Department of Revenue, 2013 NCBC 9. Presently, this case remains on the Business Court docket.


Under House Bill 1892 (enacted June 2006), N.C.G.S. §105-32.8 has been revised to now provide that, if the IRS corrects or otherwise determines a gross estate tax owed to the IRS or the amount of the maximum state death tax credit allowed to an estate, the personal representative ("PR") of the estate must file a corrected North Carolina tax return within six (6) months after the federal redetermination. The new rules will now place a six (6) month time limit upon which an amended North Carolina return must be filed. Previously, the personal representative ("PR") was given two (2) years to file an amended return.

Moreover, the new amendments to N.C.G.S. 105-32.8 also provide that if a PR fails to report a federal correction on a timely basis, then the PR forfeits any refund otherwise due from the North Carolina Department of Revenue by virtue of the redetermination. Also, watch out for the "late filing" penalty!

Note: The new rules apply to federal redeterminations made by the IRS after June 30, 2006.
PART FOUR
NORTH CAROLINA SALES AND USE TAX DEVELOPMENTS

I.  **Sales Tax Changes Under HB 998.** House Bill 998 made some modest changes to the sales tax rules. Again, most of these changes will not be effective until 2014. Some of the more interesting changes are as follows:

1.  **Manufactured Homes.** N.C.G.S. 105-164.4(a)(1a) was amended to provide that the 4.75% general sales tax rate applies to sales of manufactured homes sold at retail. Previously, sales of manufactured homes were subject to a 2% state sales tax rate with a maximum tax of $300. However, sales of manufactured homes are not subject to the local sales and use tax. N.C.G.S. 105-467(a) as amended.

2.  **Modular Homes.** N.C.G.S. 105-164.4(a)(8) has been amended to provide that the 4.75% general North Carolina state sales tax rate applies to the sale of modular homes sold at retail. Previously, sales of modular homes were subject to a maximum 2.5% state sales tax rate. As with manufactured homes, sales of modular homes will not be subject to the local county sales tax. N.C.G.S. 105-467(a) as amended.

3.  **Admission Charges.** New N.C.G.S. 105-164.4(a)(10) now provides for assessment of sales and use tax on admission charges to certain entertainment activities, such as: (a) a live performance, (b) a motion picture or film, (c) a museum, cultural site, garden, exhibit, show or similar attraction.

4.  **Service Contracts.** New N.C.G.S. 105-164.4a(11) now imposes a 4.75% sales and use tax on the sales price of a service contract. Under new N.C.G.S. 105-164.3(38b), a "service contract" is defined as a warranty agreement, a maintenance agreement, a repair contract or a similar agreement or contract by which the seller agrees to maintain or repair tangible personal property.

II.  **Repeal of Sales Tax Exemption for Sales of Newspapers.** N.C.G.S. 105-164.13(28) has been repealed effective January 2014. Previously, N.C.G.S. 105-164.13(28) provided an exemption, from sales and use tax, for the retail sale of newspapers by newspaper street vendors, by newspaper carriers making door-to-door deliveries, and by means of vending machines. Now, effective January 1, 2014, sales of newspapers by street vendors and by door-to-door newspaper carriers will be subject to the general State and local sales and use taxes. Interestingly, however, effective January 1, 2014, sales of newspapers through coin operated vending machines will be subject to sales tax on 50% of the sales price.

III.  **"Sourcing Rules" for Sales of Digital Property.** N.C.G.S. 105-164.4(a)(6b) assesses sales tax on sales of certain "digital property," such as (1) an audio work, (2) an audio-visual work, (3) a book, magazine or newsletter, or (4) a photograph or greeting card. In June 2012, N.C.G.S. 105-164.4(B)(a) was amended to provide certain "sourcing" rules to determine the applicable business location to which certain digital property is sold. In August 2013, the NCDOR issued a notice outlining how the digital "sourcing" rules work in order to determine
where the sale is deemed to have occurred. **Important Notice: Sourcing for Certain Digital Property Subject to Sales and Use Tax, North Carolina Department of Revenue, August 2013.**

IV. **Sales Tax Announcement Regarding Nurserymen, Greenhouse Operators and Landscapers.**

In December 2012, the North Carolina Department of Revenue issued a Notice regarding how the sales and use tax rules apply to nurserymen, greenhouse operators and landscapers. The Notice was issued in a "Frequently Asked Questions" format and provides long-awaited sales and use tax guidance for taxpayers in these industries. **Important Notice: Frequently Asked Questions for Nurserymen, Greenhouse Operators and Landscapers (December 2012).**

V. **Clarifying Changes to the Sales and Use Tax Exemptions for Installation Charges.**

A. **Background.** N.C.G.S. 105-164.13(37)a.5. provides the general rule that installation charges are included in the definition of "sales price" for purposes of determining sales and use tax obligations on a retail sale. However, N.C.G.S. 105-164.13(49) has always provided for a sales tax exemption for installation charges when the charges were "separately stated."

But, there has never been any clear definition as to what "separately stated" meant. Could a retailer meet the "separately stated" requirement by breaking out installation charges on a sales proposal or would it have to be broken out on the invoice? The N.C. Administrative Code has specifically provided that the installation charges had to be "separately stated on the customer's invoice and in the vendor's records." 17 N.C.A.C. 7B.0802(b).

B. **2011 Statutory Changes.** In the summer of 2011, N.C.G.S. 105-164.13(49) was amended to specifically provide that the installation charges had to be separately stated "on the invoice at the time of sale" in order for the charges to be exempt from sales tax.

C. **2012 Statutory Changes.** Senate Bill 826 made clarifying changes to the sales and use tax exemptions under N.C.G.S. 105-164.13 with respect to installation charges that are separately stated on an invoice or "on a similar billing document."

Under former law, installation charges were exempt from sales tax as long as the installation charges were "separately stated on the invoice at the time of sale."

Now, under new N.C.G.S. 105-164.13(49), installation charges will also be exempt from sales tax as long as the installation charges are "separately stated on an invoice or similar billing document given to the purchaser at the time of sale."

See new revised N.C.G.S. 105-164.13(49). Senate Bill 826 (Session Law 2012-79).
VI. Responsible Person Liability for Trust Fund Taxes

A. Background. Individual officers and directors of a corporation are usually not liable for corporate debts or obligations. General partners of a partnership, on the other hand, are always personally liable for debts and liabilities of the partnership.

B. "Responsible Person" Liability Under N.C.G.S. 105-242.2. However, by statute, a "responsible officer" of a corporation or a limited liability company may be held personally liable for certain unpaid "trust taxes" owed by the business entity, such as sales and use, motor fuels, and income withholding taxes. A "responsible officer" is defined as any of the following:

(i) the president, treasurer, and the CFO of a corporation,
(ii) the manager of an LLC, and
(iii) any other officer of a corporation or a member of a LLC who has a duty to pay trust taxes on behalf of the entity.

Note: This statute was amended in 2007 to add CFOs to the list of persons who are automatically deemed "responsible persons."

C. Now, Partners Are Added to the List of "Responsible Persons." Prior to 2008, there was no similar statutory provision to assess partners for these taxes. Instead, the Department of Revenue, like any other creditor of a partnership, had to sue the partners in order to collect this liability against the partners of a partnership. Once a judgment was obtained, the Department of Revenue had to seek to execute the judgment.

New Senate Bill 1704 (2008) amended N.C.G.S. 105-242.2 to add general partners of a partnership to the list of "responsible persons."

Note: SB 1704 also recodified N.C.G.S. 105-253 as new N.C.G.S. 105-242.2.

Effective Date: This change becomes effective July 1, 2008, and applies to taxes that become collectible on or after that date.


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.
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:

1. the consideration paid by the buyer, or
2. the fair market value of the business or stock of goods.

**Conclusion.** This case is important in that it reminds us of (1) the potential officer responsibility for unpaid sales taxes and (2) that unpaid sales taxes are a de facto lien against sold assets. Thus, where unpaid taxes remain after a business is sold or where the business ceases to exist, the Department of Revenue may proceed against the Seller or against the Seller’s responsible corporate officers or it may proceed with collection actions against the purchaser.

Under new 2007 changes, CFOs and Managers are also always responsible persons.
I. HB 998 Changes to Corporate Income Tax System.

HB 998 also made a number of changes to our North Carolina corporate income tax system, including tax rate reductions and elimination of a number of corporate income tax credits, effective for 2014 and after.

A. Corporate Tax Rate Changes. Here are the new corporate tax rates:

1. 2014 – 6% (down from 6.9%). N.C.G.S. 105-130.3.

2. 2015 – 5%. N.C.G.S. 105-130.3.

3. 2016 – If the general fund revenues exceed $20.2 Billion for fiscal year 2014-15, the rate will lower to 4%. N.C.G.S. 105.130.3A.

4. 2017 – If the general fund revenues exceed $20.975 Billion for fiscal year 2015-2016, the rate will lower to 3%. N.C.G.S. 105-130.3A.

B. Repealed Tax Credits. HB 998 repeals a number of corporate tax credits after 2013, such as the credit for conservation easements and the Article 3J credit for creating jobs. According to the North Carolina Department of Revenue, however, taxpayers that qualified for these tax credits may continue to take any remaining installments and carryforwards of those tax credits after the sunset date if the taxpayer continues to meet the statutory eligibility requirements for each particular credit. See North Carolina Department of Revenue "Important Notice: Sunset for Tax Credits – Effect on Future Installments and Carryforwards" (September 18, 2013).


Here, a C corporation was subject to the North Carolina "add back" for federal bonus depreciation. Later on, the C corporation converted to an S corporation and the S corporation shareholders attempted to take a North Carolina deduction in subsequent tax years for the North Carolina bonus depreciation "add-backs." The NCDOR disallowed the deductions. So, by converting from a C corporation to an S corporation, all of the future North Carolina bonus depreciation deductions were lost forever.
III. **New Statute Changes North Carolina Department Of Revenue Power To Adjust The Net Income Of A Corporation Or To Require A Corporation To File A Combined North Carolina Tax Return.**

A. **Background.** Previously, N.C.G.S. 105-130.6, N.C.G.S. 105-130.15 and N.C.G.S. 105.130.16 allowed the North Carolina Department of Revenue to adjust the taxable income of a North Carolina corporate taxpayer, or to require a corporate taxpayer doing business in North Carolina, to file a combined corporate income tax return with affiliated corporations if the separate entity income tax return filed by the North Carolina corporate taxpayer did not reflect the "true earnings" of the corporation from its activities in North Carolina.

Most often, the North Carolina Department of Revenue used these statutes to adjust a North Carolina corporate taxpayer's income when it believed that the North Carolina corporate taxpayer had over compensated an out-of-state affiliate for goods or services provided to the North Carolina corporate taxpayer. So, N.C.G.S. 105-130.6 and N.C.G.S. 105-130.16 allowed the North Carolina Department of Revenue to force a North Carolina corporate taxpayer to file a consolidated return with its out-of-state affiliate and allowed the North Carolina Department of Revenue to disallow or reduce deductions for amounts paid by a North Carolina corporate taxpayer to an out-of-state affiliate.

B. **New Statutory Changes.** New Session Law 2011-390 (House Bill 619) (June 30, 2011) repealed the NCDOR's statutory authority under G.S. 105-130.6, 105-130.15 and 105-130.16 to adjust a corporation's net income or require a combined return, and replaced existing authority with a new statute, N.C.G.S. 105-130.5A. The new N.C.G.S. 105-130.5A is effective for tax years beginning on or after January 1, 2012.

Effective January 1, 2012, N.C.G.S. 105-130.6 (the "forced combination" statute) and N.C.G.S. 105-130.16(a) and (b) have been repealed. Also, new N.C.G.S. 105-130.5A has been enacted to replace former N.C.G.S. 105-130.6 and N.C.G.S. 105-130.16.

Under new N.C.G.S. 105-130.5A(b), if the NCDOR determines that a corporation's intercompany transactions lack "economic substance" or are not at "fair market value," the NCDOR may redetermine the North Carolina taxable income properly attributable to business carried on in North Carolina by:

(i) adding back, eliminating, or otherwise adjusting intercompany transactions; or

(ii) requiring the corporation to file a combined return with an out-of-state affiliate.

However, the NCDOR may only require a combined return if other adjustments to intercompany transactions are not adequate to redetermine net income.
New N.C.G.S. 105-130.5A(f) defines "economic substance" for purposes of the new statute, and N.C.G.S. 105-130.5A(g) provides that, in determining whether transactions between members of an affiliated group of entities are not at "fair market value," the NCDOR shall apply the standards contained in the Regulations adopted under Section 482 of the Internal Revenue Code.

C. Effective Date of New Changes:

1. **NCDOR Assessments Proposed or Pending Before January 1, 2012.** Because the new laws do not apply until January 1, 2012, the new rules do not affect corporate income tax assessments that were proposed by the North Carolina Department of Revenue before January 1, 2012. So, this means that N.C.G.S. 105-130.6, N.C.G.S. 105-130.15(a) and N.C.G.S. 105-130.16(b) and (c) will continue to apply to any assessment proposed by the North Carolina Department of Revenue before the January 1, 2012 effective date of the new rules.

2. **Assessments Proposed On or After January 1, 2012 for Tax Years Beginning Before January 1, 2012.** N.C.G.S. 105-130.6, N.C.G.S. 105-130.15(a) and N.C.G.S. 105-130.16(b) and (c) are revised/repealed effective January 1, 2012, and are therefore not applicable to assessments proposed on or after January 1, 2012. New N.C.G.S. 105-130.5A is not effective for tax years beginning prior to January 1, 2012.

**NOTE:** The new law does not affect the Secretary's authority under other law to adjust a taxpayer's income. For example, because North Carolina has adopted federal taxable income as the starting point in determining a corporation's State net income, the NCDOR is authorized to adjust a corporation's income under judicially created doctrines, including the "economic substance" doctrine, recently codified as IRC Code Section 7701(o). In addition, the NCDOR is authorized to adjust income under applicable authority in the Internal Revenue Code, including adjusting deductions from intercompany transactions if the amounts paid are in excess of fair market value under IRC Section 482. The NCDOR will continue to rely on this other authority for assessments proposed after 2011 for pre-2012 tax years. *Important Notice Regarding the Secretary's Authority to Adjust the Net Income of a Corporation or to Require a Corporation to File A Combined Return. NCDOR July 13, 2011.*

3. **Assessments Proposed for Tax Years Beginning on or After January 1, 2012.** New N.C.G.S. 105-130.5A is effective for tax years beginning on or after January 1, 2012, and applies to assessments proposed for tax years beginning on or after that date.
IV. **NCDOR Must Issue "Forced Combination" Rules Under N.C.G.S. 105-130.5A (SB 824, June 15, 2012) Before It May Adjust Net Income or Force Filing of Combined Return.**

Taxpayers have long argued that the NCDOR has provided virtually no guidance on how it interprets the combined reporting statutes. Now, the NCDOR has been ordered to adopt rules regarding its interpretation of new N.C.G.S. 105-130.5A which was enacted in 2011.

Under this new legislation (new Section N.C.G.S. 105-262.1), the NCDOR may not redetermine North Carolina tax income or require a combined return until it adopts new rules interpreting new N.C.G.S. 105-130.5A.

See new N.C.G.S. 105-262.1.
SB 824 (Session Law 2012-43) (June 14, 2012).
PART SIX
NORTH CAROLINA DEPARTMENT OF REVENUE COLLECTION PROCEDURES

I. North Carolina Launches Second Program to Help Small Businesses with Trust Fund Tax Liabilities.

A. Introduction. In July 2011, the North Carolina Department of Revenue announced that it, along with the NC Small Business Commissions Office, was launching a new program to help some small businesses with North Carolina trust fund tax liabilities owed to the North Carolina Department of Revenue. This program, called the "Small Business Taxpayer Recovery Program" offers penalty and fee waivers, as well as deferred payment plans, to some small employers that had become delinquent in their sales, withholding and other trust fund tax liabilities.

B. New "Small Business Counseling Program." Unfortunately, this program ended on June 30 2013. However, because of the successful outcome from the first program, the NCDOR has decided to launch a second program. So, on February 20, 2013, the NCDOR issued a Press Release announcing that it is initiating a second program, called the Small Business Counseling Program.

Similar to the first program, the new program offers penalty and fee waivers as well as payment plans to employers that have fallen behind with trust fund tax payments. To qualify for the program, the business must have 200 or fewer employees and the owners must agree to attend small business counseling through counseling services offered by the Small Business and Technology Development Center or the North Carolina Small Business Small Business Center Network.

Small businesses that complete the required counseling and that file and pay all outstanding taxes will have penalties and collection fees waived. However, fees and penalty will be reinstated if the program participants fail to file or pay their taxes on time. And, as with the first program, the Small Business Counseling Program will not be available to those taxpayers who are under criminal investigation.

Although the new Small Business Counseling Program shares many similarities with the former Small Business Taxpayer Recovery Program, there are some significant differences with the new program. For example, under the new program, the business must identify and designate at least one owner or officer of the business as a "responsible person" so that if the business falls out of compliance, the NCDOR will be able to pursue personal liability against that "responsible person". Also, under the new program, if the taxpayer defaults in its installment payment obligations, that taxpayer will then be precluded from further participation in the Small Business Counseling Program.
However, one significant favorable difference in the new program is that participants will receive the benefit of up to a full two-year payment plan regardless of when these businesses enter into the program. Under the old program, taxpayers had to fully pay all taxes by June 30, 2013 regardless of when they came into the program. In contrast, under the new program, regardless of when a taxpayer comes into the program they will have up to two full years to fully pay any outstanding delinquent taxes.

II. IRS Will Begin Sharing Form 1099-K Information With the NC Department of Revenue.

Recently, the Internal Revenue Service began sharing, with the North Carolina Department of Revenue, "Form 1099-K Information" that the IRS receives. This Form 1099-K information reports third party payments to North Carolina recipients (such as through credit card processing and through PayPal accounts). Now, as a result of receiving the shared Form 1099-K information from the IRS, the North Carolina Department of Revenue will be able to track credit card deposits and credit card processing accounts of North Carolina businesses. This will give the NCDOR another tool for locating and seizing North Carolina bank accounts being used to process credit card deposits and other third party payments.

III. NC Secretary of Revenue Determines That Nurses' Aides Were Improperly Treated As Independent Contractors Rather Than As Employees.

In the case of Assured Care, Inc. vs. Department of Revenue, NCDOR 11 Rev. 02148 (December 8, 2011), the Secretary of Revenue determined that a taxpayer was liable for delinquent personal income withholding taxes, interest and penalties where it improperly misclassified certain nurse aides as independent contractors rather than as employees.

A. Background. In determining whether a person should be classified as an employee versus an independent contractor, the NCDOR relies on IRS Publication 15-A which reviews the "common law" 20 factor test to determine whether someone should be treated as an independent contractor or employee for federal income and employment tax purposes. This 20-factor common law test reviews the relationship between the worker and the business and focuses heavily on the extent to which the business has "behavioral control" or "financial control" over the relationship.

B. Assured Care, Inc. In the Assured Care, Inc. case, the nurses' aides were subject to policies and procedures implemented by the taxpayer and thus the Department of Revenue concluded that the taxpayer-business had "behavioral control" over the nurses' aides. Also, the business had "financial control" over the nurses' aides, since the aides had very few unreimbursed business expenses and were paid an hourly rate, and therefore the nurses' aides could not realize a profit or a loss when conducting services for the business.

Moreover, even though the business and the nurses' aides had previously entered into written contracts, specifying that the nurses' aides would be treated as independent contractors, this factor was irrelevant, since the overall evidence indicated both "behavioral control" and "financial control" that the taxpayer-business had over the nurses' aides.
As a result, the taxpayer-business was liable for personal income withholding taxes, interest and penalties.

IV. **Governor Perdue's Executive Order No. 125 Establishes the Governor's Task Force on Fighting Employee Misclassification (August 22, 2012).**

A. **Introduction.** On August 22, 2012, Governor Perdue signed a new Executive Order (No. 125) to create a new task force to combat employee misclassification. According to the Executive Order, the Governor's Office believes that many North Carolina businesses are misclassifying true employees as independent contractors in order to avoid compliance with health, safety and licensing requirements, as well as to avoid paying income and payroll taxes on employee wages.

B. **Goals of New Task Force According to the Executive Order.** The new Task Force will serve as "an effective tool for promoting cooperation and the sharing of information between state agencies as well as for identifying effective mechanisms to decrease instances" by which entities violate the law by misclassifying their workers as independent contractors rather than as employees.

C. **Members of the New Task Force.** The new Task Force will be made up of, among others, representatives from the following North Carolina agencies: the Industrial Commission, the Department of Revenue, the Department of Public Safety, the Department of Commerce, the Division of Employment Security, as well as the Commission of Insurance.

D. **Duties of the New Task Force.** The list of duties of the new Task Force include:

   (a) identifying sectors of the economy where employee misclassification occurs most;

   (b) utilizing a cooperative approach in working with employers and the community to reduce employee misclassification through better education and raising public awareness;

   (c) determining regulatory or other changes in the state laws to enhance efforts to enforce those laws that prohibit employee misclassification;

   (d) identify ways to increase the filing of complaints by employees against non-compliant employers;

   (e) formulate new methods for preventing employment misclassification;

   (f) solicit the assistance of law enforcement agencies and district attorneys with the goal of implementing effective procedures for referring appropriate cases for prosecution where appropriate; and
(g) promulgate methods for sharing relevant information between members of the Task Force.

E. **Observation.** Clearly, the new Task Force will likely increase the number of ESC and NCDOR employment tax audits and we may well see a significant increase in tax assessments, penalties and perhaps even criminal prosecution. We may also see increased legislation and regulatory authority to address the perceived employee/independent contractor misclassification problems.

V. **North Carolina Can No Longer Use "Contingent Fee" Based Contractors for Audit or Assessment Purposes.**

For a long time, North Carolina has contracted with independent contracting third parties (on a contingency fee basis) for collecting delinquent tax debts.

Under new N.C.G.S. 105-243.1 (H.B. 462), new legislation was enacted which prohibits the State of North Carolina (or any county) from entering into contingent fee based contracts for tax audit or tax assessment purposes. (H.B. 462).

**Effective Date:** This new change is effective as of July 1, 2012, and applies to tax audit and tax assessment contracts entered into after that date. Also see the conformed revisions to N.C.G.S. 105-243-1(a1); N.C.G.S. 105-299; N.C.G.S. 116 B-8; and N.C.G.S. 153A-146.

House Bill 462 (Session Law 2012-152).

VI. **New Changes to the North Carolina Innocent Spouse Relief Rules For Understatements of Tax.**

Previously, under the innocent spouse relief rules of N.C.G.S. 105-152(e), a North Carolina spouse could receive innocent spouse relief for his or her spouse's understatement of tax only if that taxpayer had received similar innocent spouse relief for a federal tax liability. N.C.G.S. 105-152(e) now has been amended to now provide that a requesting innocent spouse qualifies for innocent spouse relief (for North Carolina tax purposes) for a spouse's understatement of tax, if the North Carolina spouse could qualify for innocent spouse relief under the federal Section 6015 rules, even if the innocent spouse had not actually applied for innocent spouse relief under the federal Section 6015 tax rules.

**Note:** Prior to this change, the taxpayer requesting North Carolina Innocent Spouse relief would actually have had to receive federal innocent spouse relief in order to be eligible to receive state NC innocent spouse relief.

SB 826 (Session Law 2012-79).
VII. **NCDOR Announces Changes to Its Offer in Compromise Process.**

On July 9, 2012, the NCDOR issued a Press Release announcing changes to its Offer in Compromise Program. North Carolina now will use the IRS expense standards in order to determine disposable income for purposes of determining whether the taxpayer qualifies for an OIC. Also, under the new program, the NCDOR will also provide a counter-offer when an original OIC offer is denied. These changes will reduce the number of criteria taxpayers must meet in order to qualify for a North Carolina OIC.

In its July 9, 2012 press release, the NCDOR advised that it believes that the simplified and improved OIC process will result in an increase in number of OICs (i) submitted by taxpayers and (ii) accepted by the NCDOR.


The NCDOR has issued guidelines for taxpayers to follow when requesting a private letter ruling ("PLR") to determine an application of a North Carolina tax law to a taxpayer's specific fact pattern. Taxpayers, who receive a favorable PLR request, will not be responsible for any future tax, interest or penalties incurred as a result of any contrary position taken by the NCDOR in a future NCDOR audit regarding the specified tax issue. In other words, if a North Carolina taxpayer receives a favorable PLR, then the PLR will be "binding" on the NCDOR with respect to the tax issue at hand.

The new guidance provides guidelines for taxpayers to follow when requesting a PLR from the NCDOR.

Taxpayers should fill out and submit a Form NC-PLR, "Request for Private Letter Ruling" to request a private letter ruling. As Form NC-PLR indicates, in order to request a private letter ruling, the taxpayer must identify itself (with full legal name, address, phone number and EIN) and must supply all material facts relating to its business. In addition, the taxpayer must set forth, in the PLR request, its position as to applicability of the North Carolina tax laws.

Finally, the new NCDOR announcement also sets forth "user fees" that must be paid by the taxpayer when requesting a PLR. The normal fee is $500 per tax issue, but there is an increased user fee of $5,000 for requests for "expedited" private letter rulings. An "expedited private letter ruling" is a request for written advice that the NCDOR agrees to provide within 90 days. Private Letter Ruling and Letters of General Applicability, NCDOR (January 2012).
IX. Responsible Person Liability for Trust Fund Taxes.

A. Background. Individual officers and directors of a corporation are usually not liable for corporate debts or obligations. General partners of a partnership, on the other hand, are always personally liable for debts and liabilities of the partnership.

B. "Responsible Person" Liability Under N.C.G.S. 105-242.2. However, by statute, a "responsible officer" of a corporation or a limited liability company may be held personally liable for certain unpaid "trust taxes" owed by the business entity, such as sales and use, motor fuels, and income withholding taxes. A "responsible officer" is defined as any of the following:

   (i) the president, treasurer, and the CFO of a corporation,

   (ii) the manager of an LLC, and

   (iii) any other officer of a corporation or a member of a LLC who has a duty to pay trust taxes on behalf of the entity.

Note: This statute was amended in 2007 to add CFOs to the list of persons who are automatically deemed "responsible persons."

C. Now, Partners Are Added to the List of "Responsible Persons." Prior to 2008, there was no similar statutory provision to assess partners for these taxes. Instead, the Department of Revenue, like any other creditor of a partnership, had to sue the partners in order to collect this liability against the partners of a partnership. Once a judgment was obtained, the Department of Revenue had to seek to execute the judgment.

   New Senate Bill 1704 (2008) amended N.C.G.S. 105-242.2 to add general partners of a partnership to the list of "responsible persons."

Note: SB 1704 also recodified N.C.G.S. 105-253 as new N.C.G.S. 105-242.2.

Effective Date: This change becomes effective July 1, 2008, and applies to taxes that become collectible on or after that date.
PART SEVEN
OTHER NOTABLE DEVELOPMENTS -- WHAT WE DID NOT SEE IN HB 998.

Although HB 998 included and made a number of significant changes to North Carolina's tax system, there were a number of sweeping proposals that never made it to the final legislation. Prior to the passage of HB 998, a number of bills were introduced in the House and Senate that never made it into the final legislation. Here are some examples of "what we didn't see:"

A. Sales Tax Proposals. Except for making service contracts fully subject to the North Carolina sales tax, the sales tax was not extended to other services (such as professional services) nor was it extended to cover sales and leases of real property – as proposed in other bills.

B. Corporate Tax Proposals. Although we did see overall rate reductions, we did not get full income tax repeal as called for in some proposals. And, there were no changes to the franchise tax system.

C. Personal Income Tax Proposals. The final HB 998 legislation reduced the personal tax rates, but does not provide for complete repeal as was included in some proposed bills. However, the charitable contribution deductions were not reduced, except for those who do not itemize.

D. Future Considerations for the Revenue Laws Study Committee. The Revenue Laws Study Committee has been directed to further consider a number of proposals and provisions that did not make it into the final HB 998 Legislation, such as:

1. Privilege taxes on businesses;

2. The possibility of further reductions to the corporate tax rates, presumably based upon whether the general fund revenues exceed certain future threshold amounts;

3. Simplification of (and possible elimination of) the corporate franchise tax system; and

4. Expanding the sales tax base to include certain services.

Let's see what the future holds!