

State Taxation

The General Assembly enacted \$18.7 million of net tax reductions for fiscal year 2008–09 and \$79.1 million of net tax reductions for fiscal year 2009–10. The most notable tax reductions are the repeal of the gift tax and the increase in the state refundable earned income tax credit. The tax reductions also include several new tax exemptions, refunds, and credits. Tax credits are one of many economic incentives offered by the state designed to attract and maintain businesses in North Carolina. Many of the state’s economic tax incentives have sunset dates as a means to review and reevaluate those credits to determine whether they are accomplishing their intended goal. During the 2008 session, the General Assembly extended or modified the sunset on several of these credits. The General Assembly also enacted a procedure for tax class actions as well as an act that provides small businesses with certain protections related to their sales and use tax obligations.

Small Business Protection Act

During the 2008 session the Senate and House Finance Committees heard from a number of small business owners who expressed concern and confusion regarding the application of certain sales and use-tax provisions to their particular businesses and, in some instances, verbal information provided by the Department of Revenue (DOR) that they believed to be erroneous or unclear. Section 28.16 of S.L. 2008-107 (H 2436) addresses many of the expressed concerns. It provides small businesses with certain protections related to their sales and use-tax obligations, requires DOR to establish and implement procedures for improving customer service and quality control measures with regard to advice given to taxpayers in certain

areas of the tax law, and directs the Revenue Laws Study Committee to study issues related to the interpretation and application of certain areas of the sales and use-tax law.

Also under this section, the Secretary of Revenue is required to reduce an assessment for sales and use taxes made against a small business as the result of an audit and waive any associated penalties if all of the following conditions are met:

- The annual gross receipts of the business and all related persons for the calendar year preceding the year in which the audit period begins do not exceed \$1.8 million dollars.
- The business remitted all the sales and use taxes it collected during the audit period.
- The business had not been told by DOR in a prior audit to collect sales and use taxes in the circumstance that is the basis of the assessment.
- The business made a good faith effort to comply with the sales and use-tax laws, and the assessment is based on the incorrect application of one of the following complex areas of these laws:
 - the rate of tax that applies to prepared food;
 - the distinction between a retailer and a performance contractor
 - the distinction between a service that is necessary to complete the sale of tangible personal property, which is taxable, and a service that is incidental to the sale of tangible personal property, which is not taxable; or
 - the determination of whether a person is a manufacturer.

Table 26–1. Assessment Reduction

Average Monthly Gross Receipts	Reduction of Assessment (%)
0–50,000	98
50,001–100,000	95
100,001–150,000	90

The amount of the reduction is a percentage of the assessment and varies depending on the average monthly gross receipts of the business as detailed below in Table 26–1.

In addition to applying prospectively to future assessments and claims for the refund of an assessment, Section 28.16 of S.L. 2008-107 also has limited retroactive application. Specifically, it applies to assessments that are pending as of July 15, 2008, to assessments that have been identified in a notice of final assessment under former G.S. 105-241.1 prior to July 15, 2008, or to assessments that became collectible but have not been paid as of July 15, 2008. If, however, an assessment was paid within six months after it became collectible, then the taxpayer may also be eligible for a reduction if a timely claim for refund could be filed.

This section attempts to address either the actual or perceived issues of quality control within DOR with respect to verbal advice given to taxpayers. Specifically, this section requires DOR to document certain conversations with taxpayers, regardless of whether the conversation is conducted by phone or in person. Effective January 1, 2009, DOR must document advice given to a taxpayer when the taxpayer provides identifying information, asks about the application of a tax to the taxpayer in specific circumstances, and requests that the Secretary of Revenue document the advice in the taxpayer’s records. The documentation must set out the date of the conversation, the question asked, and the advice given. This requirement does not apply in a conference or presentation type setting. Effective July 1, 2009, DOR must document in a similar manner a conversation with a taxpayer who is not registered as a retailer or a wholesale merchant under Article 5 (Sales and Use Tax) of G.S. Chapter 105 when the taxpayer identifies himself or herself, describes the business in which he or she is engaged, and asks if he or she is required to be registered under Article 5.

Under current law a taxpayer may request in writing specific advice from DOR. If DOR furnishes erroneous written advice in response and the taxpayer reasonably relies on that advice, the taxpayer is not liable for any penalty or additional assessment attributable to the erroneous advice. However, the same protection does not apply with regard to verbal advice. This same protection, which became effective July, 16, 2008, is extended to taxpayers with regard to erroneous verbal advice provided that DOR records establish that the erroneous advice was given.

This section rewrites the offer and compromise statute so that it more accurately reflects current practice, is adjusted for inflation, and eliminates the requirement that DOR obtain approval from the Attorney General unless the matter is in litigation. It also adds a new condition under which DOR may settle a tax liability for less than that asserted to be due; that is, when the collection of an amount greater than the amount offered would produce an unjust result under the circumstances. The rewrite of this statute is intended, in part, to provide DOR with additional flexibility with regard to offers and compromise.

This section requires DOR to do two things. First, DOR must establish and implement by July 1, 2010, a plan to record telephone calls received at the Taxpayer Assistance Center for training, customer service, and quality control purposes. Second, DOR must report to the Revenue Laws Study Committee, prior to the convening of the 2009 General Assembly, on customer service improvement initiatives.

Sales Tax Changes

Exemption of Disaster Assistance Debit Sales

Section 28.6 of S.L. 2008-107 (H 2436) exempts from sales tax tangible personal property purchased with a client assistance debit card issued for disaster assistance relief by a state agency or a federal agency or instrumentality. The American Red Cross (ARC) is an instrumentality of a federal agency. Another example of a federal agency or instrumentality that may utilize this exemption would be the Federal Emergency Management Agency (FEMA). This section became effective for purchases made on or after August 1, 2008.

A state may not impose its sales tax on purchases made by the federal government or an instrumentality of the federal government. G.S. 105-164.13(17) specifically exempts from North Carolina sales tax “sales which a state would be without power to tax under the limitations of the Constitution or laws of the United States or under the Constitution of this State.” Sales made pursuant to a disbursing order issued by a federal governmental agency or instrumentality is considered a sale to the government that is exempt from taxation. However, for purposes of the sales tax exemption, there is a significant difference between a debit card and a disbursing order: the purchaser, for purposes of the sales tax exemption, is the disaster victim when a debit card is used, and it is the disbursing entity when the disbursing order is used. Section 28.6 of S.L. 2008-107 extends the same sales tax treatment that exists for purchases made through a disbursing order issued by a federal agency or instrumentality to purchases made with a client assistance debit card issued by it.

Sales Tax Holiday for Certain Energy Star Rated Appliances

Section 28.12 of S.L. 2008-107 creates a state and local sales and use-tax exemption, applicable during the first weekend in November, for the following Energy Star rated products: clothes washers, freezers and refrigerators, central air conditioners and room air conditioners, air source heat pumps and geothermal heat pumps, ceiling fans, dehumidifiers, and programmable thermostats. An Energy Star rated product is one that meets the energy efficient guidelines set by the United States Environmental Protection Agency and the United States Department of Energy and is authorized to carry the Energy Star label. The exemption does not apply to the sale of a product for use in a trade or business or to the rental of a product. This section became effective when the governor signed the act into law on July 16, 2008.

State Sales Tax Exemption for Baked Goods Sold by Artisan Bakeries

For several years North Carolina has grappled with the issue of the taxation of bakery items. The term *bakery item* is a subset of the defined term *prepared food*. North Carolina imposes a higher sales tax rate on prepared food than food. The distinction between food and prepared food often becomes complex. The Senate Finance Committee heard testimony from many small bakeries across the state that they received conflicting information about the applicable tax rate they should impose on their bakery items. The conflicting information resulted in many bakeries being assessed additional tax, along with interest and penalties, because they taxed their bakery items at the incorrect, lower rate. The bakeries also argued that the differential tax rates imposed an unfair economic burden on their goods.

Section 28.19 of S.L. 2008-107 reduces the sales tax applicable to bakery items sold without eating utensils by an artisan bakery by exempting those items from the general state sales tax rate. Bakery items include bread, rolls, buns, biscuits, bagels, croissants, pastries, donuts, danish, cakes, tortes, pies, tarts, muffins, bars, cookies, and tortillas. Effective January 1, 2009, bakery items sold without eating utensils by an artisan bakery will be taxed at the applicable local sales tax rate, as opposed to the combined general rate applicable to prepared foods. An artisan bakery is one that meets both of the following requirements:

- It derives over 80 percent of its gross receipts from bakery items.
- Its annual gross receipts, combined with the gross receipts of all related persons, do not exceed \$1.8 million.

Prohibition of Tax on Interior Design Services

For sales and use-tax purposes the definition of *sales price* is the total amount or consideration for which tangible personal property is sold, leased, or rented. The consideration may be in the form of cash, credit, property, or services necessary to complete the sale. Over the past several months, DOR audited some interior designers and decorators and assessed sales tax on services it found necessary to complete the sale of the tangible personal property sold by the designers or decorators. Many of the interior designers and decorators appealed the assessment of the tax and brought the issue to the attention of legislators.

Section 28.20 of S.L. 2008-107 specifically exempts interior design services provided in conjunction with the sale of tangible personal property from the sales and use tax. This section became effective August 1, 2008. It does not affect the assessments imposed under the prior law. It also does not address other transactions in which the tangible personal property transferred is largely the result of personal services. The legislation directs the Revenue Laws Study Committee to examine the taxation of services necessary to complete the sale of tangible personal property and the standards for distinguishing between a service that is taxable as one that is necessary to complete the sale and a service that is incidental to the sale of tangible personal property.

Cap on Excise Tax for Machinery Refurbishers

Section 28.21 of S.L. 2008-107 expands Article 5F (Manufacturing Fuel and Certain Machinery and Equipment) of G.S. Chapter 105 to provide that the 1 percent privilege tax, with a cap of \$80, applies to an industrial machinery refurbishing company that purchases equipment, or an attachment or repair part for equipment, used by the company in repairing or refurbishing tangible personal property owned by a third party. Property subject to the excise tax under Article 5F is exempt from sales and use tax. The change from a sales tax to a privilege tax not only means a lower tax rate for the property purchased but also means that retailers are not responsible for collecting and remitting the tax. The change became effective for purchases made on or after July 1, 2008.

Clarification of the 501(c)(3) Sales Tax Refund

G.S. 105-164.14 provided a semiannual state and local sales and use-tax refund to a nonprofit, charitable institution. DOR had to determine whether a nonprofit entity requesting a sales and use-tax refund qualified as a "charitable institution." To make its determination, DOR relied on past determinations and court decisions. In May 2008 the North Carolina Court of Appeals appeared to expand the definition of charitable institution in

The Lynnwood Foundation v. N.C. Department of Revenue, when it affirmed a trial court's ruling that DOR erred in denying a sales and use-tax refund to the foundation.

Section 28.22 of S.L. 2008-107 seeks to clarify the law, not expand it, by providing a bright line test for determining whether a nonprofit entity is a charitable one. The section, which became effective July 1, 2008, provides that a nonprofit entity may receive a sales tax refund if it is exempt from income tax under section 501(c)(3) of the Internal Revenue Code (IRC) but not designated as one of the following organizations under the National Taxonomy of Exempt Entities (NTEE):

- Community improvement, capacity building organization
- Public, society benefit, multipurpose organization
- Mutual/membership benefits organization

The NTEE is a classification system categorizing charitable organizations with 501(c)(3) status by organizational mission into twenty-six subgroups based on Internal Revenue Service (IRS) activity codes. The activity codes provide detail on the operational activities of an organization that has been granted 501(c)(3) status. The IRS assigns an activity code to a charitable organization based on information provided by the organization at the time of application for 501(c)(3) status.

Sales Tax Refund for Certain Nonprofits

Direct purchases by a state agency, which by definition includes The University of North Carolina (UNC), may be exempt from state and local sales and use tax. A state agency may also receive a quarterly refund of local sales and use taxes paid by it indirectly on building materials, supplies, fixtures, and equipment that become part of a facility owned or leased by the agency. S.L. 2008-154 (H 2509) provides similar sales and use tax treatment to a nonprofit entity that procures, designs, constructs, or provides facilities to a constituent institution of UNC by expanding the list of nonprofit organizations allowed a semiannual refund of sales and use-tax to include this type of nonprofit organization. The act specifically allows the refund to an entity exempt from taxation as a disregarded entity of such a nonprofit organization. This act is applicable to purchases made on or after January 1, 2004. A refund claim for the period January 1, 2004, through December 31, 2007, was considered timely filed if it was submitted to DOR by October 15, 2008.

The act provides a refund to a type of nonprofit entity that was denied a sales tax refund from DOR in 2004 on the grounds that the nonprofit organization did not qualify as one of the statutorily eligible entities. One such entity, Affinity Housing LLC, filed a lawsuit against DOR challenging the department's denial of its refund claim. Affinity Housing LLC is a single-member LLC of Western Carolina University Research and Development Corporation, a Section 501(c)(3) nonprofit entity formed to

aid and promote the educational and charitable purposes of WCU. Affinity Housing LLC constructs housing facilities for WCU. The act makes the application of the change retroactive to January 1, 2004, and applicable to purchases made on or after that date. This time period will allow Affinity Housing LLC to receive the refund it originally sought.

Constituent institutions of UNC have begun to use nonprofit organizations to procure, design, and construct facilities, such as student housing and dining facilities, on their behalf. An institution leases property to a nonprofit organization, and the nonprofit organization constructs the facility on the property. The institution leases the facility from the nonprofit and usually operates and manages the facility. The lease payments made by the institution, recouped through rents charged to students, enable the nonprofit to pay the indebtedness on the facility. At the conclusion of the lease and the retirement of the debt, the ownership of the facility lies with the institution. The General Assembly recognized the trend in 2004, when it expanded the property tax exemption for educational property by exempting property held by a nonprofit entity for the sole benefit of a university located in the state and by expanding the definition of educational purposes to include the operation of a student housing facility or a student dining facility.

UNC's outsourcing of its capital construction responsibilities continues to evolve. The institutions have found that privatized facility projects cost less to construct and are completed sooner than traditional facility projects, primarily because the projects are not subject to the state's bidding laws and construction process. At its inception some of the financing was private financing. Increasingly, the financing is secured through self-liquidating revenue bonds. Today most of these projects are included in the bond projects submitted to the General Assembly for its approval by UNC. The Office of the State Treasurer exercises oversight of the lease agreements between the institutions and the nonprofit entities.

Personal Taxes

Gift Tax Repeal

Section 28.18 of S.L. 2008-107 repeals North Carolina's gift tax law, effective January 1, 2009. The nuances of North Carolina's gift tax laws make the transfer of property through gifts difficult and complicate estate planning. The North Carolina Association of Certified Public Accountants and the Estate and Gift Tax Section of the North Carolina Bar Association have consistently recommended that North Carolina eliminate or simplify its gift tax law. With the repeal of the gift tax in North Carolina, Connecticut and Tennessee remain the only two states in the nation to impose a tax on gifts.

Estate Tax Changes

Section 28.17 of S.L. 2008-107 modifies the formula for calculating North Carolina estate tax on estates that include property located in another state by excluding the value of that property from the estate tax payable to North Carolina. The section became effective July 16, 2008, and applies retroactively to the estates of decedents for which the statute of limitations for claiming a refund had not expired on December 27, 2007. A case has been filed in Mecklenburg County, *Stowe v. Department of Revenue*, to recover North Carolina estate taxes imposed on property located in South Carolina. The plaintiffs argue in their complaint that the formula for calculating North Carolina estate tax due when property is located in more than one state is unconstitutional because it provides less than a full reduction of the tax attributable to the out of state property when the other state does not impose an estate tax, or imposes an estate tax less than the prorated federal credit amount. The plaintiffs filed the complaint on December 27, 2007.

A personal representative of an estate for which the statute of limitations had not expired may file a claim for refund under G.S. 105-241.6. The statute provides that the general statute of limitations for obtaining a refund of an overpayment of tax is the later of the following:

- three years after the due date of the return, or
- two years after payment of the tax.

A North Carolina estate tax return is due on the date a federal estate tax return is due. A federal estate tax return is due nine months from the date of death. An extension of time to file a federal estate tax return is an automatic extension of the time to file a state tax return.

Increase in Earned Income Tax Credit

Section 28.9 of S.L. 2008-107 increases the amount of the state's refundable earned income tax credit from 3.5 percent of an individual's federal earned income tax credit amount to 5 percent, effective for taxable years beginning on or after January 1, 2009. The General Assembly enacted a refundable state earned income tax credit in 2007, effective for taxable years beginning on or after January 1, 2008. The amount of the federal credit varies depending upon whether the taxpayer has children and the amount of earned income the taxpayer has. The credit is phased out as the taxpayer's earned income rises. The earned income amounts and the credit amounts are indexed annually to inflation.

Tax Deduction for the Sale of a Manufactured Home Community to Manufactured Homeowners

North Carolina's calculation of state taxable income begins with federal taxable income. Section 28.27 of S.L. 2008-107 allows a taxpayer to deduct from federal taxable income, and thus from state income tax, the taxable gain from a qualified sale of a manufactured home community. A *qualified sale* is a sale of land comprising a manufactured home community that is transferred in a single purchase to a group composed of a majority of the manufactured home community leaseholders, or to a nonprofit organization representing such a group. To qualify for this deduction, the taxpayer must give notice of the sale to the North Carolina Housing Finance Agency (NCHFA). The deduction is applicable to taxable years beginning on or after January 1, 2008, and it expires for taxable years beginning on or after January 1, 2015.

Expansion of the Renewable Energy Tax Credit

North Carolina provides a tax credit for investing in renewable energy property. The credit amount is equal to 35 percent of the cost of the property placed in service. Renewable energy property includes biomass equipment that uses renewable biomass resources for biofuel production of ethanol, methanol, and biodiesel; commercial thermal or electrical generation from renewable energy crops or wood waste materials; hydroelectric generators; solar energy equipment; and wind equipment. The credit may be taken against either the franchise tax or the income tax of the taxpayer, and it may not exceed 50 percent of the tax against which it is claimed. The credit expires for renewable energy property placed into service on or after January 1, 2011.

Last session, S.L. 2007-397 expanded the concept of this tax credit to include a charitable contribution to a tax exempt nonprofit organization for the purpose of providing funds for the organization to invest in renewable energy property. The amount of credit allowable to the donating taxpayer is equal to the following calculation:

$$(\text{taxpayer's donation} \div \text{cost of the renewable energy property of governmental entity placed in service that year as a result of the donation}) \times \text{the amount of the credit the governmental entity could claim if it were subject to tax.}$$

Section 28.25 of S.L. 2008-107 extends the tax credit enacted last session to include similar donations made to a unit of state or local government, effective for taxable years beginning on or after January 1, 2008. The credit must be taken in the year in which the property is placed in service. A taxpayer who claims this credit may not also claim the donation as a charitable contribution. Moreover, the total amount of the

credit may not exceed the amount of the credit the governmental entity could claim under G.S. 105-129.16A if it were subject to tax, which for nonresidential property, is capped at \$2.5 million.

A governmental entity must keep a record of all donations it receives for renewable energy property and the amount of the donations used for this purpose. If the entity places renewable energy property in service, it must give each taxpayer who made a donation a statement setting out the amount of the credit the taxpayer qualifies for, a description of the renewable energy property placed in service, the cost of the property, the amount of the credit the entity could claim under G.S. 105-129.16A if it were subject to tax, and the taxpayer's share of the credit allowed. If the donations made for the renewable energy property exceed the cost of the property, the entity must prorate each taxpayer's share of the credit.

Corporate Tax Changes

IRC Update

Section 28.1 of S.L. 2008-107 updates from January 1, 2007, to May 1, 2008, the reference to the IRC used in defining and determining certain state tax provisions. With one major exception, changing the reference date to May 1, 2008, incorporates into state tax law the changes made by the following acts: the Economic Stimulus Act of 2008, the Mortgage Forgiveness Debt Relief Act of 2007, and the Small Business and Work Opportunity Tax Act of 2007. This section became effective for taxable years beginning on or after January 1, 2008.

The one major exception concerns the application of the bonus depreciation provision. Unlike federal law, Section 28.1 of S.L. 2008-107 requires an 85 percent add back of the bonus depreciation allowed under the Economic Stimulus Act of 2008 in order to achieve revenue neutrality for fiscal year 2008-09. Over the life of an asset placed in service during 2008, taxpayers will be able to deduct the same amount of the asset's basis under both federal and state law; the timing of the deduction will differ, however. To accomplish this decoupling, the section does two things:

- It requires a taxpayer to add back to federal taxable income 85 percent of the accelerated depreciation amount in the year the accelerated depreciation is claimed for federal purposes.
- In tax years beginning on or after January 1, 2009, it allows a taxpayer to deduct from federal taxable income the total amount of the add back required for either the 2007 or 2008 tax year, divided into five equal installments.

The decoupling, for state tax purposes, means a taxpayer may deduct a greater depreciation amount in the outlying tax years, which will be

the normal depreciation amount plus 20 percent of the accelerated depreciation amount the taxpayer had to add back. The purpose of this recovery provision is to enable the taxpayer to have the same basis in assets for federal and state purposes. Without this deduction provision, a taxpayer would have a different basis in the depreciable asset for state and federal purposes and would have to keep separate books and records for state and federal purposes until the disposal of the asset. In effect, the add back and the subsequent deduction will affect the timing of the impact of bonus depreciation on the state but it will not increase or decrease the total amount of revenue the state receives over the affected years.

Closing of Franchise Tax Loopholes

Section 28.7 of S.L. 2008-107 changes the franchise tax laws, effective for taxable years beginning on or after January 1, 2009, to conform with changes the General Assembly made to the corporate income tax laws in 2006 and 2007.

First, the act provides that limited liability companies (LLCs) that elect to be taxed as S corporations for income tax purposes are subject to the franchise tax in the same manner as other S corporations. Prior to 2006 a LLC did not pay franchise tax. In 2006 the General Assembly amended the definition of *corporation*, as it applies to the franchise tax statutes, to include a LLC that elects to be taxed as a C corporation for federal income tax purposes. DOR began to receive questions from S corporations as to whether they could convert to a LLC and elect to be treated as an S corporation for income tax purposes, thereby becoming exempt from franchise tax. To curb this potential franchise tax loophole, Section 28.7 of S.L. 2008-107 makes a similar change to the one enacted in 2006; it provides that a LLC that elects to be treated as a corporation for income tax purposes, either a C corporation or an S corporation, is also considered a corporation for franchise tax purposes.

Second, the act provides that captive real estate investment trusts (REITs) are subject to the franchise tax since they are treated as corporations for income tax purposes. In 2007 the General Assembly limited a corporation's ability to use captive REITs to avoid state taxes by disallowing the dividend paid deduction when a REIT is a captive REIT. The effect of this change is that a captive REIT is treated as a regular corporation for income tax purposes. Section 28.7 of S.L. 2008-107 provides that a captive REIT will also be treated as a regular corporation for franchise tax purposes. Under the current franchise tax law a REIT may, in determining its value for franchise tax purposes, deduct the aggregate market value of its investments in the stocks, bonds, debentures, or other securities or evidences of debt of other corporations, partnerships, individuals, municipalities, governmental agencies, or governments. This section changes the statute to provide that this deduction may only be

used by a REIT that is not a captive REIT. A REIT is an organization that uses the pooled capital of many investors to purchase and manage real estate. A captive REIT is one that is owned or controlled by a single entity.

Publicly Traded Partnerships

A partnership doing business in North Carolina must file an information return with DOR that gives the name and address of each person who would be entitled to share in the partnership's net income, if distributable, and the amount each person's distributive share would be. A partnership that files a report must also furnish to each partner the information needed by that partner to file a North Carolina income tax return. For nonresident members of a partnership, the partnership must pay income tax for that partner based on the partner's distributive share.

Section 28.8 of S.L. 2008-107 changes the reporting and payment requirements that apply to a publicly traded partnership (PTP) that is described in section 7704(c) of the IRC. It requires a qualifying PTP to report annually to the department the partners in the PTP who received more than \$500 of income rather than report the income received by every partner. It also exempts qualifying PTPs from the requirement to pay tax on the partnership income received by a nonresident. The Revenue Laws Study Committee recommended this tax law change. In making this recommendation, the committee sought to strike a balance between the costs and burden of compliance with the reporting requirements for both the PTPs and DOR and the benefits gained by compliance. This section is effective for taxable years beginning on or after January 1, 2008.

A PTP is a limited partnership the interests in which are traded on stock exchanges such as the New York, American, and NASDAQ exchanges. Unlike a traditional partnership, a PTP has tens of thousands, and sometimes hundreds of thousands, of unitholders. A PTP's unitholders can change daily in trades on public exchanges. A PTP determines who its unitholders are once a year so the PTP can send K 1s to the unitholders. A PTP described in section 7704(c) of the IRC is one that generates 90 percent of its income from qualified sources. Qualified sources include real estate activities; mineral or natural resources activities like exploration, production, mining, refining, marketing; and transportation of oil, gas, minerals, geothermal energy, and timber. There are approximately ninety PTPs in the country that meet the description in section 7704(c) of the IRC, and ten of these PTPs are located in North Carolina.

Economic Incentives

Extension of the Research and Development Credit

Section 28.2 of S.L. 2008-107 extends the sunset on the income tax credit for research and development for five years, until the year 2014. Prior to the enactment of this section, the credit was scheduled to expire for taxable years beginning on or after January 1, 2009. The credit amount varies. For North Carolina university research expenses, the credit amount is equal to 20 percent of the amount a taxpayer paid to the university for the research and development. For all other qualified research expenses, the credit is equal to a percentage of the expenses. Specifically, the rate is 3.25 percent for small businesses and for research and development conducted in a development tier one area. For other research and development expenditures, the rate ranges from 1.25 percent to 3.25 percent as the amount of those expenditures increases.

Extension of the Low Income Housing Credit

Section 28.3 of S.L. 2008-107 extends the sunset on the low income housing tax credit from January 1, 2010, until January 1, 2015. Although the sunset was not scheduled to expire for two more years, developers of low income housing begin their work months in advance and need to know what financing will be available as they secure options on sites.

In 1999 North Carolina authorized a state income tax credit modeled after the federal housing credit. A taxpayer may elect to receive the credit in the form of either a credit against tax liability or a loan generated by transferring the credit to the NCHFA in return for a 0-percent interest thirty-year balloon loan equal to the credit amount. Historically, project developers have almost always elected the loan option. Neither a tax refund generated by the credit, nor a loan received as a result of the transfer of the credit is considered taxable income by the state. Although a state tax refund is considered taxable income by the IRS if the taxpayer itemizes deductions, a private letter ruling from the IRS provides that the loan proceeds are not.

Extension of the Mill Rehabilitation Tax Credit

North Carolina allows a tax credit for rehabilitating vacant historic manufacturing sites if the taxpayer spends at least \$3 million to rehabilitate the site and meets other qualifying conditions. The credit expires for qualified rehabilitation expenses occurring on or after January 1, 2011. Section 28.4 of S.L. 2008-107 extends the sunset to include projects for which an application for an eligibility certification is submitted on or after January 1, 2011.

The amount of the tax credit for rehabilitating a vacant historic manufacturing site is a percentage of the qualified rehabilitation expenditures, and the percentage varies depending on the enterprise tier location of the site and the eligibility for the federal credit. The credit may be claimed against the franchise tax, the income tax, or the gross premiums tax. Any unused portion of the credit may be carried forward for the succeeding nine years. This credit may be taken in place of the credit for historic rehabilitation, not in addition to it.

Extension of the State Ports Tax Credit

Section 28.5 of S.L. 2008-107 extends the sunset on the income tax credit for using the state's ports for five years, until the year 2014. Prior to the enactment of this section, the credit was scheduled to expire for taxable years beginning on or after January 1, 2009. In 1992 the General Assembly enacted the state ports tax credit to encourage exporters to use the two state owned port terminals in Wilmington and Morehead City. At that time the credit applied to amounts paid by a taxpayer on any cargo exported at either port. Over the years the credit has been expanded, and the sunset has been extended four times.

Extension of the Small Business Employee Health Benefits Credit

Section 28.9 of S.L. 2008-107 extends from January 1, 2009, to January 1, 2010, the sunset on the income tax credit available to a small business that pays at least 50 percent of the health insurance premiums for its employees. The credit amount is equal to \$250 per employee for whom a taxpayer pays the health insurance premium, not to exceed the taxpayer's cost of providing the health insurance benefit. The taxpayer may use the credit against either its income tax or its franchise tax liability. The credit may not exceed 50 percent of the taxpayer's tax liability. Any unused portions of the credit may be carried forward for five years.

Extension of Aviation Fuel Refunds

Section 28.23 of S.L. 2008-107 extends the sunset for refunds of the state sales and use tax paid on fuel used by interstate passenger air carriers and on aviation fuel used by a professional motorsports racing team or a motorsports sanctioning body from January 1, 2009, to January 1, 2011. To receive a refund a taxpayer must submit a refund request in writing and include any information and documentation required by the Secretary of Revenue. The request is due within six months after the end of the calendar year for which the refund is claimed.

In 2005 the General Assembly provided a sales and use-tax refund to an interstate passenger air carrier for the net amount of sales and use tax paid by it on fuel during a calendar year in excess of \$2.5 million. The *net*

amount of sales and use taxes paid is the amount of sales tax paid by the interstate passenger air carrier less the refund of that tax allowed to all interstate carriers under subsection (a) of G.S. 105-164.14. The refund for which the sunset provision is being extended is in addition to the refund allowed under G.S. 105-164.14(a).

In that same year the General Assembly enacted a refund of sales and use taxes paid on aviation fuel by a motorsports racing team or motorsports sanctioning body. In order to qualify for the refund, the fuel must have been used to travel to or from a motorsports event in North Carolina, from North Carolina to a motorsports event in another state, or to North Carolina from a motorsports event in another state. For the purposes of the refund, a *motorsports event* includes a motorsports race, a motorsports sponsor event, and motorsports testing.

Expansion and Extension of the Film Industry Credit

Section 28.24 of S.L. 2008-107 (H 2436) extends for four years, until January 1, 2014, the sunset on the tax credit for investing in the film industry. This credit is a refundable income tax credit equal to 15 percent of the qualifying expenses spent by a production company in connection with a production. The amount of the credit with respect to a feature film production is capped at \$7.5 million. In order to obtain the credit, a taxpayer must have qualifying expenses in excess of \$250,000. Qualifying expenses are the total amount spent in North Carolina for the following:

- goods and services purchased by a production company in connection with a production
- compensation and wages paid by a production company on which it remitted withholding payments to the Department of Revenue.

Under prior law any amount paid to an individual who receives in excess of \$1 million with respect to a single production may not be included in a qualifying expense. Section 28.24 of S.L. 2008-107 modifies the limitation by allowing a production company to include in its qualifying expenses up to \$1 million in compensation paid to a highly compensated individual. Any amount paid in excess of \$1 million continues to be disallowed.

In addition to extending the sunset and modifying the limitation on highly paid individuals, this section makes the following three changes to the credit:

- It allows a production company to include in its qualifying expenses the cost of insurance coverage for production related insurance that is obtained on the production. The expenses do not qualify if the insurance coverage is purchased from a related member, which is defined in the current law.

- It requires a taxpayer who claims the credit to file an intent to film notice with the North Carolina Film Office. The notice must include the name of the production, the name of the production company, the name of a financial contact for the production company, the proposed dates on which the production company plans to begin filming the production, and any other information required by the NC Film Office. This provision codifies current administrative practice.
- It requires a taxpayer to acknowledge in the production credits both the NC Film Office and the regional film office responsible for the geographic area in which the filming of the production occurred.

Increase in the Qualified Business Venture Tax Credit Cap

Section 28.26 of S.L. 2008-107 increases from \$7 million to \$7.5 million the total amount of all qualified business investment credits that may be taken each year. Demand for the credit exceeded \$7 million in 2006 and totaled more than \$6.5 million in 2007. This section is effective for investments made on or after January 1, 2008.

The qualified business investment tax credit is allowed for an individual taxpayer who purchases the equity securities or subordinated debt of a qualified business venture, a qualified grantee business, or a qualified licensee business directly from that business. The credit is equal to 25 percent of the amount invested and may not exceed \$50,000 per individual in a single taxable year. An individual investor may also claim the allocable share of credits obtained by pass through entities of which the investor is an owner. Pass through entities include limited partnerships, general partnerships, S corporations, and limited liability companies. The credit may not be taken in the year the investment is made. Instead, the credit is taken in the year following the calendar year in which the investment was made, but only if the taxpayer files an application with the Secretary of Revenue. Any unused credit may be carried forward for the next five years. The Secretary of Revenue calculates the total amount of tax credits claimed from applications filed. If the amount exceeds the cap, then the Secretary of Revenue allows a portion of the tax credits claimed by allocating the total amount of credits allowed in proportion to the size of the credit claimed by each taxpayer. In general a taxpayer forfeits the credit if the taxpayer transfers the securities within one year or the qualified business redeems the securities purchased by the taxpayer within five years after the investment was made. This credit is currently set to expire for investments made on or after January 1, 2011.

Solar Electricity Generating Materials Manufacturing Credit

Section 3.10 of S.L. 2008-118 (H 2438) adds “solar electricity generating materials manufacturing” to the list of industries entitled to an annual refund of the sales and use tax paid by the owner of the industry on building materials and supplies, fixtures, and equipment used to construct a facility that will be used primarily to manufacture solar electricity generating materials. Solar electricity generating materials manufacturing is defined as the development and production of one or more of the following:

- photovoltaic (PV) materials or modules used in producing electricity
- polymers or polymer film primarily intended for incorporation into photovoltaic materials or modules used in producing electricity

To be eligible for this refund, the Secretary of Commerce must certify that the owner of the facility will invest at least \$50 million of private funds in the construction of the facility if the facility is located in a development tier one area and at least \$100 million if the facility is located elsewhere in the state. In addition to the investment requirement, a solar electricity generating materials manufacturing business must also meet a wage standard in order to qualify for the sales tax refund. A business meets the wage standard if it pays the lesser of an average weekly wage that is equal to or greater than 105 percent of the average weekly wage for the state or the average weekly wage for the county.

If the owner does not make the required minimum investment within five years after the first refund is received, the owner forfeits all refunds already received. Upon forfeiture the owner is liable for not only the tax due, but also for interest computed from the date each refund was received. A person that fails to pay the tax and interest due within thirty days after the date of forfeiture is subject to the penalties provided in G.S. 105-236. A request for a refund must be in writing and must be submitted within six months after the end of the state’s fiscal year. A refund applied for after the due date is barred. The refund provision became effective July 1, 2008, and applies to purchases made on or after that date; it expires for purchases made on or after January 1, 2013.

PVs are solar cells made and composed of semiconductor materials that are used to convert sunlight directly into electricity. DuPont is a materials and technology supplier to the PV industry. It offers products needed for PV module production, such as polymer films, resins, sheets, and conductive pastes. DuPont has one facility in Bladen County and another in Kentucky that produce polymers needed to manufacture polymer film. The company is looking to expand this industry. United

Solar Ovonic is a company headquartered in Michigan that specializes in thin film solar technologies and the manufacture of thin film solar electric modules and laminates. It, too, is looking to expand its operations.

Land Sales in Multijurisdictional Industrial Parks and Increase in the JDIG Cap

Any two or more counties may enter into contracts or agreements to jointly undertake the development of an industrial or commercial park or site. The lowest development tier incentive status is granted to the entire multijurisdictional industrial park (MIP), regardless of the tier designation of each individual county, if certain criteria are met. One of the criteria is that there be 250 developable acres in each county where the park is located. As a county sells property in the MIP to businesses to carry out the purposes of the MIP, it may not be able to meet the prerequisite number of acres it must own in the MIP. S.L. 2008-147 (S 2075) clarifies that the sale of parcels of land from a MIP for industrial or commercial purposes does not change the original tier status of the MIP or availability of the incentives to successive purchasers based on its original tier status.

The act also temporarily raises the maximum amount of total annual liability for grants for agreements entered into in calendar year 2008 under the Job Development Investment Grant Program from \$15 million to \$25 million.

Other State Tax Law Changes

Procedure for Tax Class Actions

Section 28.28 of S.L. 2008-107 establishes a procedure for taxpayers seeking to initiate or join a class action in order to obtain a refund of tax paid due to an alleged unconstitutional statute. This section became effective for civil actions filed on or after October 1, 2008.

The Revenue Laws Study Committee spent a significant amount of time examining this issue. Prompted by requests from both the North Carolina Bar Association and the North Carolina Association of Certified Public Accountants, the committee first examined the issue in 2002. The committee revisited the issue in 2006 as part of its broader, in-depth study of the procedures related to the review of disputed tax matters. Most recently, in its report to the 2008 Regular Session General Assembly, the committee determined that the existing law needed to be clarified because of ambiguity surrounding recent judicial interpretations of the “protest statute,” G.S. 105-267, which was the prior mechanism for bringing a civil suit for a refund of tax. The purpose of this legislation is to identify and protect the potential liability of the state for tax refunds and to give taxpayers, DOR, and practitioners clear guidance as to the proper procedure governing tax-related class actions.

Authority. Neither the law prior to 2007, nor the law in place prior to the effective date of this act expressly allows for a class action for the refund of a tax. However, the North Carolina courts have allowed civil actions brought under the former protest statute to be certified as class actions. A new statute, G.S. 105-241.17, governs the conditions under which a civil action may be initiated by a taxpayer for the refund of a tax based on the alleged unconstitutionality of a statute. However, the statute is silent with regard to class actions. This section provides specific statutory authority for tax class actions, which may be brought only on the grounds of an alleged unconstitutional statute.

Bringing a tax class action. A taxpayer who wishes to commence a class action challenging the constitutionality of a tax statute and who seeks to represent the class must meet certain requirements. First, the taxpayer must meet the same requirements that any other taxpayer is required to meet in order to bring a civil action. Those requirements are as follows:

- The taxpayer must receive a final determination from DOR after a review and conference.
- The taxpayer must commence a contested case at the Office of Administrative Hearings (OAH).
- OAH subsequently dismissed the case for lack of jurisdiction because the sole issue in the case is the facial constitutionality of a statute.
- The taxpayer has paid the tax, penalties, and interest due in the final determination.
- The civil action is filed within two years of the dismissal from OAH.

Second, the taxpayer must also comply with any requirements under Rule 23 of the North Carolina Rules of Civil Procedure. North Carolina courts have required compliance with Rule 23 in prior tax class actions, so the requirement is not new, but this section sets out the requirement explicitly in statute.

Finally, this section adds a new requirement for bringing a tax class action. The taxpayer’s claims must be typical of the claims of the class members in order for the taxpayer to serve as the class representative. This language mirrors language in Rule 23 of the Federal Rules of Civil Procedure. Whether a claim is “typical” is an issue for the court to determine when approving the class representative.

Joining a tax class action. In order to become a member of a tax class action, a taxpayer must be eligible and must affirmatively elect to participate as a member of the class. A taxpayer is eligible to become a member of the class if the taxpayer could have filed a claim for refund as of the date the class action was commenced or as of a subsequent date set

by the court, whether or not the person actually filed a claim. For purposes of determining this eligibility, a class action “commences” upon the later of the date a complaint is filed alleging the existence of a class or the date a complaint is amended to allege the existence of a class. An eligible taxpayer becomes a member of a class by affirmatively indicating a desire to be included in the class in response to a notice of the class action. A taxpayer who joins a class is not required to exhaust the administrative review process; only the class representative must do so.

Procedure. The procedure for notifying potential class members, the content of the notice, and the method by which potential class members indicate a desire to be included in the class in response to the notice must be approved by the court. This procedure may include ordering DOR to provide the class representative with a list of names and last known addresses of all taxpayers who are readily determinable by the department and are eligible to become a member of the class. The class representative must advance the costs of notification.

Statute of limitations. As discussed above, the general statute of limitations for obtaining a refund of overpayment of tax is the later of three years after the due date of the return or two years after payment of the tax. Without a class action mechanism, each taxpayer seeking a refund of a tax paid under an alleged unconstitutional statute would have to file a claim for refund within the statute of limitations period and exhaust the administrative and judicial review process.

One general principle of class actions is that the filing of a suit tolls the statute of limitations for all prospective class members until class certification is denied. If certification is denied, the limitations period begins to run again and plaintiffs may file their own individual claims. This same principle applies to tax class actions. The statute of limitations for filing a claim for refund on the grounds of an unconstitutional statute is tolled for a taxpayer who is eligible to become a member of a class action. The tolling begins on the date the class action is commenced. For a taxpayer who does not join the class, the tolling ends when the taxpayer does not affirmatively indicate a desire to be included in the class as provided by the court. For a taxpayer who does join the class, the tolling ends when the court enters any of the following:

- a final order denying certification of the class
- a final order decertifying the class
- a final order dismissing the class action without an adjudication on the merits
- a final judgment on the merits

Effect on nonparticipating taxpayers. Class actions are designed to adjudicate, in a single action, the claims of numerous parties with similar claims. One objective of a class action judgment is to prevent future litigation of claims that were, or could have been, litigated in the

class action. Thus the legal principles of “claim preclusion” and “issue preclusion” arise in the class action context. *Claim preclusion* means that a final judgment on the merits in a case is conclusive as to the rights of the parties to that case and bars them from bringing a subsequent action involving the same claim. In the class action context, the application of claim preclusion means that the judgment applies to the entire certified class. In certain instances, it can also bind nonparties. It does not, however, bar an individual who elects not to participate in the class action from bringing his or her own claim. *Issue preclusion* bars the same parties from relitigating in a subsequent action an issue that was litigated in a prior action. Courts have generally held that a successful defendant in a prior class action suit may not assert issue preclusion in a subsequent suit against a plaintiff who opted out of the earlier class action. Similarly, when a class prevails in an earlier action, an individual who opted out of that class who now chooses to bring his or her own individual claim against the same defendant may not assert issue preclusion in that case.

This section provides that the principles of claim preclusion and issue preclusion apply to tax class actions in the same manner in which they apply to class actions generally. It further specifies that if a final judgment on the merits is entered in a class action in favor of the class, the following applies to an eligible taxpayer who did not become a member of the class:

- The taxpayer is not entitled to share in any monetary relief awarded to the class.
- If the taxpayer has been assessed for failure to pay the tax at issue in the class action and the taxpayer has not paid the assessment, then the assessment is abated.
- The taxpayer is relieved of any future liability for the tax that is the subject of the class action.

Home Inspector Privilege License

S.L. 2008–206 (H 2558) imposes an annual state privilege license tax of \$50 on an individual licensed under the Home Inspector Licensure Act. Article 9F (North Carolina Home Inspector Licensure Board) of G.S. Chapter 143 requires home inspectors and associate home inspectors to be licensed. The state privilege license tax imposed under this act applies to both types of licenses.

The state’s privilege license tax is imposed on a fiscal year basis and is due by July 1 of each year. The full amount of the tax applies to a person who, during the fiscal year, begins to engage in an activity for which a privilege license is required. Because the act became effective after July 1, 2008, it includes a provision extending the time in which a person engaged in the business of home inspection has to obtain the required state license for fiscal year 2008–09, from July 1, 2008, until October 1, 2008.

By imposing a state license tax on this profession, the act repeals the authority of cities to impose a local license tax on this profession. Under the general authority of G.S. 160A-211, several cities impose a privilege license tax on home inspectors. Since many of these cities have already collected the tax for fiscal year 2008–09, the act specifically authorizes its imposition and collection by those cities for this fiscal year. A city cannot impose a license tax on this profession for fiscal years beginning on or after July 1, 2009.

An individual required to have a state privilege license may not engage in the licensed activity until a license is obtained. To obtain a license, an individual must file a completed application with DOR and pay the required tax. An application for a license is considered a return. The license does not of itself authorize the practice of a profession, business, or trade for which a state qualification license is required.

Solid Waste Disposal Tax Changes

S.L. 2008-207 (H 2530) makes several administrative changes to the solid waste disposal tax enacted by the General Assembly last session in S.L. 2007-550. The solid waste disposal tax became effective July 1, 2008. The rate of tax is \$2 per ton of waste to be imposed on the disposal of municipal solid waste in landfills in the state and on the transfer of municipal solid waste for disposal outside the state. The purpose of the tax is to help offset the cost of the assessment and remediation of pre-1983 landfills and to provide additional resources for solid waste management programs and services. The tax proceeds are allocated to cities, counties, and state agencies.

This act clarifies that the tax and the return are due on a quarterly basis. Second, it provides that the taxpayer may deduct the tax paid in the following circumstances:

- If a third party fails to pay the amount charged for the disposal of waste tonnage and an owner or operator has deducted that amount from gross income as a bad debt, then the owner or operator may deduct the amount of that tonnage if the tax was paid on the tonnage.
- If the owner or operator is not subject to income tax, the owner or operator may take the deduction when it is determined that the charges are not collectible.

Finally, the act excludes a city or county from receiving proceeds if it does not provide solid waste management programs and services and is not responsible by contract for payment, unless the city or county is served by a regional solid waste management authority. If the city or county is served by the authority, then the city or county must forward the amount of proceeds it receives to that authority. To assist DOR with distribution,

the Department of Environment and Natural Resources must provide the department with a list of cities and counties that are excluded by May 15 of each year.

Unsalable OTP Refund

In S.L. 2007-323, the General Assembly increased the excise tax levied on other tobacco products (OTP) from 3 percent to 10 percent of the cost price of the products, effective October 1, 2007. The additional revenue generated by this tax is remitted by the Secretary of Revenue to the University Cancer Research Fund. S.L. 2008-207 permits wholesale and retail dealers who possess unsalable OTPs to return them to the manufacturer and apply for a refund of the excise tax paid on them. A similar provision already exists for cigarettes and cigars. The act applies to products returned on or after October 1, 2008.

Supplemental PEG Support

In 2006 the General Assembly established uniform taxes for video programming services by applying the combined general rate of sales tax to all video programming services and by repealing the authority local governments had to impose a local franchise tax. It preserved the local government revenue stream by distributing part of the sales tax revenues from telecommunications and video programming services to the counties and cities, based on the amount of cable franchise tax imposed during the first six months of fiscal year 2006–07 plus any subscriber fees imposed during that same period.

Of the revenue distributable to local governments, \$2 million a year is allocated for supplemental PEG channel support. A PEG channel is a public, educational, or governmental access channel provided to a county or city. The \$2 million allocation is distributed to counties and cities with qualifying PEG channels. The annual amount per qualifying PEG channel is \$25,000. A county or city may not receive supplemental PEG channel support for more than three PEG channels. The amount distributed to a county or city as supplemental PEG channel support must be used by it for the operation and support of PEG channels. If the total amount distributed for qualifying PEG channels in a fiscal year is less than \$2 million, the Secretary of Revenue must credit the excess amount to the PEG Channel Fund to be used for matching local grants for PEG channel support.

When the General Assembly considered the legislation in 2006, the available data indicated there would be thirty-six qualifying PEG channels. For the March 2008 distribution DOR received PEG channel certifications for 276 channels. Some of the discrepancy is believed to be due to confusion on the form used by the department that may have resulted in some channels being double counted or receiving a distribution when they did not qualify.

S.L. 2008-148 (S 1716) clarifies the distribution requirements, reduces the number of channels receiving the distribution, and provides that all qualifying PEG channels receive supplemental PEG support funding. The act defines in the distribution statute what constitutes a “qualifying PEG channel” as a channel with character generated programming that does not exceed 15 percent of eight hours of scheduled programming and is operated for at least ninety days during the year. A county or city must certify all qualifying PEG channels and allocate the proceeds it receives equally among all of its certified PEG channels. A distribution must be made to the PEG channel within thirty days of the county or city’s receipt of the supplemental PEG support revenue. This modifies the prior law, in which a county or city could only receive supplemental funding for three PEG channels. These changes address the concerns of some qualifying PEG channels regarding whether supplemental funding is being distributed fairly among the channels by ensuring all of the following:

- Each qualifying PEG channel receives supplemental funding, even if a county or city has more than three qualifying channels.
- Each qualifying PEG channel receives an equal amount of funding.
- Each qualifying PEG channel receives the funding in a timely manner.

The act also defines a PEG channel operator, requires a county or city to include the name of the PEG channel operator for each qualifying PEG channel it certifies, and requires the county or city to distribute the proceeds to the PEG channel operator. This change better ensures that the money is distributed by the local government for the use of

the PEG channels. In addition, where a single PEG channel has more than one operator or the PEG channel is claimed by more than one local government, the change ensures that the funds go to the operator of the PEG channel. It limits a PEG channel operator from being included in multiple certifications for the same PEG channel, which should reduce the number of qualifying PEG channels by eliminating much of the double counting that currently occurs. The act also provides a method to account for revenues that are distributed in error by requiring any county or city that received a distribution in error to submit a revised certification and return all funds received in error. Such funds are added to the amount to be distributed in the following year as supplemental PEG support funding.

Finally, the act allows the Secretary of Revenue to request additional information and extends from July 15, 2008, to September 15, 2008, the period of time a county and city has to make its certification in 2008. The act permits DOR to make the distribution of supplemental PEG channel support for the quarter ending June 30, 2008, based upon the qualifying PEG channel certifications in effect for fiscal year 2007–08 distributions.

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